

CHARLES & COLVARD LTD
Form 10-K
March 31, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2008

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: 000-23329

Charles & Colvard, Ltd.

(Exact Name of Registrant as Specified in Its Charter)

North Carolina
(State or Other Jurisdiction of Incorporation)

56-1928817
(I.R.S. Employer Identification No.)

300 Perimeter Park Drive, Suite A, Morrisville, N.C.
(Address of Principal Executive Offices)

27560
(Zip Code)

Registrant's telephone number, including area code: (919) 468-0399

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class
Common Stock, no par value per share*

Name of Each Exchange on Which Registered
The NASDAQ Stock Market LLC

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(NASDAQ Global Select Market)

* Includes associated Right to Purchase Series A Junior Participating Preferred Stock
Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of June 30, 2008, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates of the registrant was \$17,241,292 based on the closing sales price as reported on the NASDAQ Global Select Market.

As of February 28, 2009, there were 18,437,398 outstanding shares of the registrant's common stock.

DOCUMENT INCORPORATED BY REFERENCE

Certain portions of the Proxy Statement for the Company's 2009 Annual Meeting of Shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Statements expressing expectations regarding our future and projections relating to products, sales, revenues and earnings are typical of such statements and are made under the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about our plans, objectives, representations and contentions and are not historical facts and typically are identified by use of terms such as may, will, should, could, expect, plan, anticipate, believe, estimate, predict, potential, continue and similar words, although some forward-looking statements are expressed differently.

All forward-looking statements are subject to the risks and uncertainties inherent in predicting the future. You should be aware that although the forward-looking statements included herein represent management's current judgment and expectations, our actual results may differ materially from those projected, stated or implied in these forward-looking statements as a result of many factors, including, but not limited to the recent downturn in the worldwide economy and its ongoing impact on our business and the business of our customers and suppliers, any continued trends in the general economy that would adversely affect consumer spending, a further decline in our sales, dependence on consumer acceptance of the Company's products, dependence on Cree, Inc. as the current supplier of most of the raw material, ability to develop a material second source of supply, dependence on a limited number of customers, risks of conducting operations in foreign countries, dependence on third parties, continued listing of our common stock on the NASDAQ Global Select Market, the impact of significant changes in our management on our ability to execute our business strategy in the near term and the impact of adverse resolution of legal proceedings on our operating results or financial condition. These and other risks and uncertainties, many of which are addressed in more detail below in the sections entitled Item 1A. Risk Factors and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, could cause our actual results and developments to be materially different from those expressed or implied by any of these forward-looking statements. We undertake no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur except as required by the federal securities laws, and you are urged to review and consider disclosures that we make in our reports that we file with the Securities and Exchange Commission, including this Annual Report on Form 10-K, that discuss other factors relevant to our business.

PART I

ITEM 1. BUSINESS

Introduction

We are Charles & Colvard, Ltd., a North Carolina corporation founded in 1995 (the Company or Charles & Colvard, which may be referred to as we, us or our) that manufactures, markets and distributes Charles & Colvard created Moissanite (also called moissanite or moissanite jewels) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral found primarily in meteors. As the sole manufacturer of scientifically-made moissanite jewels, our strategy is to establish Charles & Colvard as a reputable, high-quality and sophisticated brand and build demand by promoting moissanite as a unique jewel, distinct from all others based on its exceptional fire, brilliance, luster, durability and rarity.

Our moissanite jewels are made from SiC crystals. We obtain the majority of our SiC crystals from Cree, Inc. (Cree). In February 2005, we established a new relationship for the supply of SiC crystals with Norstel AB, a Swedish Company (Norstel), that has demonstrated an ability to produce suitable SiC crystals in limited quantities. We have certain exclusive supply rights with Cree and Norstel for SiC crystals to be used for gemstone applications.

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We operate as a single business segment. U.S. sales have been 70%, 82%, and 88% of total sales for the years ended December 31, 2008, 2007, and 2006, respectively. Our four largest customers in 2008 (Stuller, Inc. (Stuller), Reeves Park, Inc. (Reeves Park), Richline Group, and Samuel Aaron, Inc. (SAI)) collectively represented 48% of our total sales.

Our results of operations are discussed in more detail under Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K. Please refer to the Balance Sheets and Statements of Operations included in Item 8, Financial Statements and Supplementary Data of this Annual Report on Form 10-K for information regarding our total assets, revenue from operations and net income.

Moissanite

Moissanite is a rare, naturally occurring mineral found primarily in meteors. Naturally occurring moissanite crystals are scarce, generally very small in size, dark green or black in color and typically are not a commercially viable source of gemstone material. Therefore, we expect only lab-grown SiC crystals to provide a meaningful source of moissanite for jewels.

It is generally accepted that, in addition to carat size, the most important characteristics of a gemstone are beauty, durability and rarity. The beauty of a gemstone is characterized by its color, brilliance, dispersion (fire), and luster. The brilliance of a gemstone is measured by its refractive index, or the extent, when coupled with the facet design, to which the gemstone reflects light. The fire of a gemstone, or the breaking of light rays into spectral colors, is measured by its dispersion. Luster is the amount of light that is reflected back to the observer from the surface of a gemstone. The durability of a gemstone is determined by its hardness, or resistance to scratching, and its toughness, or resistance to chipping or cleaving. The gemstone's hardness also determines the extent to which brilliance and fire can be highlighted by cutting the gemstone with sharp, well-defined and highly polished facets. Rarity is the availability or perceived availability of a gemstone.

Moissanite jewels have unique fire, brilliance, luster, durability and rarity. The refractive index and the fire of moissanite jewels are higher than those found in other gemstones. We believe that the hardness of moissanite jewels is greater than all known gemstone materials except diamond. As a result, moissanite jewels, like diamond, can be cut with sharp, well-defined and highly polished facets that accentuate their brilliance and fire. The cutting specifications (facet arrangement and proportions) for moissanite jewels are designed to maximize the brilliance and fire inherent in the material. Additionally, we evaluate the finished jewels to exacting standards with automated video-imaging equipment and specially trained quality control personnel. Due to the rare natural occurrence of moissanite and both the proprietary and technical limitations in producing mass quantities of jewel quality moissanite, we believe that moissanite is among the rarest of jewels.

Because of its unique atomic structure, moissanite can be grown in a variety of colors including blue, green or yellow. Additionally, although none have, to the best of our knowledge, been produced to date, the colors red and pink are theoretically possible to grow. To date, we have focused our development, manufacturing and distribution efforts on near-colorless moissanite jewels, although we have produced and sold limited quantities of green moissanite jewels.

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The following table compares the physical properties of moissanite jewels with other fine gemstone materials:

Comparison Chart ⁽¹⁾

Description	Refractive Index	Dispersion	Luster	Hardness (Mohs Scale) ⁽²⁾	Toughness
Charles & Colvard created Moissanite ⁽³⁾	2.65-2.69	0.104	20.4%	9 1/4	Excellent
Diamond	2.42	0.044	17.2%	10	Good*
Cubic Zirconia (CZ)	2.17	0.060	13.6%	8 1/2	Good
Ruby	1.77	1.018	7.7%	9	Excellent**
Sapphire	1.77	0.018	7.7%	9	Excellent**
Emerald	1.58	0.014	5.1%	7 1/2	Good to Poor

* In cleavage direction, otherwise excellent

** Except twinned stones

- Sources: Gemological Institute of America, Gem Reference Guide for GIA Colored Stones, Gem Identification and Colored Stone Grading Courses 32-35, 65-82, 87-90 (1995); Cornelius S. Hurlburt, Jr. & Robert C. Kammerling, Gemology 320-324 (2d Ed. 1991); Kirk-Othmer, Encyclopedia of Chemical Technology 891-906 (4th Ed. 1994); Institution Of Electrical Engineers, Properties of Silicon Carbide (Gary L. Harris, Ed., 1995); Robert Webster, Gems: Their Sources, Descriptions and Identification 889-940 (5th Ed. 1994); W. Von Muench, Silicon Carbide in Landolt-Boemstein Numerical Data and Functional Relationships in Science and Technology, New Series, Group III, Vol. 17C, pp. 403-416 and 585-592 (M. Schultz and H. Weiss, Eds., 1984); Kurt Nassau, Shane F. McClure, Shane Elen & James E. Shigley, Synthetic Moissanite: A New Diamond Substitute , Gems & Gemology, Winter 1997, 260-275; Kurt Nassau, Moissanite: A New Synthetic Gemstone Material , Journal of Gemmology, 425-438 (1999).
- The Mohs Scale is a relative scale only, and quantitative comparisons of different gemstone materials cannot be made directly using the Mohs Scale. Moissanite jewels are approximately one-half to one-third as hard as diamond.
- With the exception of the Moissanite: A New Synthetic Gemstone Material and Synthetic Moissanite: A New Diamond Substitute articles, the physical properties of moissanite jewels set forth in the preceding table utilized materials from SiC crystals produced by parties other than Cree or us. These crystals had various sizes, colors and atomic structures that we believe made them unsuitable for use as a gemstone. We have conducted tests on the hardness, toughness and refractive index of samples of Charles & Colvard created Moissanite, and the results of these tests are consistent with the results reported in this table.

Products and Product Development

Moissanite Jewels. We primarily sell near-colorless moissanite jewels cut in a variety of shapes including round, square brilliant, radiant, cushion, oval, marquise, pear, baguette, rose, and heart in sizes ranging from 2 to 12mm (approximately 0.03 to 5.3 carats). We have produced and distribute a limited quantity of green moissanite jewels to evaluate the market potential of colored moissanite. We may elect to offer, from time to time, additional cuts, sizes and colors of moissanite jewels.

We significantly reduced our raw material purchase commitments in 2008 over prior years to improve cash flow from operations. Further, we were able to negotiate with our two leading raw material suppliers to defer purchases during the three months ended December 31, 2008 into 2009, while keeping in place our long-term supply agreements. We expect these reduced and deferred purchase commitments to help us convert inventory into cash at a faster rate. Our raw material purchases in 2008, 2007, and 2006 were \$2.2 million, \$11.5 million, and \$14.7 million, respectively. We have yet to finalize our 2009 purchase commitments, but we expect to purchase less material in 2009 than we purchased in 2008. Our raw material inventories of SiC crystals are purchased under exclusive supply agreements with a limited number of suppliers that

restrict the sale of these crystals to only us. This arrangement has resulted in the purchase of more inventory than we would otherwise maintain.

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Amended and Restated Exclusive Supply Agreement with Cree. In June 1997, we entered into an Amended and Restated Exclusive Supply Agreement (Exclusive Supply Agreement) with Cree pursuant to which we have agreed to purchase from Cree at least 50%, by dollar volume, of our SiC crystal requirements for the production of gemstones in each calendar quarter during the term of the Exclusive Supply Agreement and Cree has agreed to supply this amount of crystals to us. We purchased from Cree approximately \$1.7 million, \$11.4 million, and \$14.6 million of SiC Crystals during 2008, 2007, and 2006, respectively. Our price per gram for purchases from Cree during 2008 increased by approximately 22% over what we paid per gram in the fourth quarter of 2007 and 33% over what we paid per gram during the first three quarters of 2007. In September 2008, we amended and supplemented our letter agreement with Cree to suspend our commitment to purchase \$710,000 of silicon carbide inventory from Cree during the fourth quarter of 2008. This purchase commitment will be included in the Company s yet to be established 2009 purchase commitment with Cree.

Under the Exclusive Supply Agreement, Cree has agreed not to sell SiC crystals for gemstone applications to anyone other than us. When our orders for SiC crystals exceed the capacity of the existing crystal growth systems, Cree may, at its sole discretion, require us to purchase the additional growth systems needed or fund the cost of the systems on its own and recoup its costs by incorporating the costs of the additional systems into the cost of the SiC crystals. If we fund the costs of the crystal growth systems, Cree must use 100% of the output from these systems for our needs, unless the excess production exceeds our then-current needs, in which case Cree may sell such SiC crystals to any of its other customers for any use other than jewel applications. The title to these crystal growth systems passes to Cree once we have fully depreciated them. If Cree elects to fund the cost of additional growth systems on its own, we have no assurance that Cree will sell all of the output from these crystal growth systems to us or fill all of our orders, but Cree will be obligated to use the capacity to supply the quantities that we are required to purchase. Additionally, when Cree adds new crystal growth systems, we must commit to purchase all of the output of the new systems for at least six months. Any delay or reduction in the availability of SiC crystals from Cree could delay or limit our ability to deliver and sell our moissanite jewels, which would have a material adverse effect on our operating results.

The Exclusive Supply Agreement had an initial term through June 2005, and in January 2005 we exercised our option to extend the Agreement until July 2015.

The Exclusive Supply Agreement with Cree prohibits us, without Cree s consent, from entering into an exclusive marketing or distribution agreement with any party that Cree reasonably believes is affiliated with any of the following parties:

DeBeers;

the Central Selling Organization (the international cartel of diamond producers) or its successors;

any party whose primary business is the development, manufacture, marketing or sale of diamond gemstones; or

any non-gemstone and non-jewelry industry competitor of Cree.

These provisions may limit our potentially available avenues of distribution and could prevent us from entering into certain potentially profitable transactions.

Exclusive Supply Agreement with Norstel. In February 2005, we entered into an exclusive supply agreement with Norstel for the supply of SiC crystals for use in the manufacturing of moissanite jewels. This agreement gives us the exclusive right to purchase SiC crystals from Norstel for the purpose of fabricating, distributing, or selling faceted jewels. In April 2008, we entered into an amendment to this exclusive supply agreement due to an update of Norstel s delivery schedule and capability and also due to our desire to limit our purchase of raw materials. Under the April 2008 amendment, the Company s minimum purchase commitment from Norstel continues until (i) the Company has purchased an aggregate amount of approximately \$7.9 million of SiC crystals, or (ii) September 26, 2011, whichever

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occurs first. We purchased from Norstel approximately \$453,000 of SiC crystals during 2008 and \$550,000 of SiC crystals since inception of the exclusive supply agreement. In October 2008, the Company entered into a new letter agreement with Norstel which amended and supplemented the April 2008 amendment. Pursuant to the new letter agreement, the Company's commitment to purchase approximately \$750,000 of silicon carbide raw material inventory from Norstel during the fourth quarter of 2008 was suspended and the Company will resume purchasing from Norstel in 2009. It is not yet determined what the Company's total commitment from Norstel will be for 2009, although we have committed to purchase a minimum of 40% of our quarterly SiC requirements from Norstel. In addition, we advanced \$400,000 to Norstel in 2005 for the purchase of certain equipment. This advance, which is in the form of a note receivable, began to be repaid in January 2007 through a 20% reduction on the invoice for subsequent purchases of SiC crystals. Effective March 1, 2008, pursuant to the April 2008 amendment, we began receiving a 30% reduction on the invoice for subsequent purchases of SiC crystals from Norstel, and will continue to receive this reduction until the advance is repaid. The balance on the advance as of December 31, 2008 was \$224,627.

Intellectual Property

We have U.S. product and method patents for moissanite jewels, expiring in 2015, under which we have broad, exclusive rights to manufacture, use and sell moissanite jewels in the United States. We have these same patents in a number of foreign jurisdictions. In addition, we have certain trademarks and pending trademark applications that support the Charles & Colvard moissanite branding strategy. Although we intend to enforce our patent and trademark rights, we cannot be sure that such actions will be successful, that any additional patents will be issued, that any issued patent will not be challenged, invalidated or circumvented or that any issued patent will have any competitive or commercial value.

Our success and our ability to compete successfully depend heavily upon our proprietary technology. In addition to our patents, we rely on trade secret laws and employee, consultant and customer confidentiality agreements to protect certain aspects of our technology. We cannot be sure that we will be able to protect our proprietary technology from disclosure or that others will not develop technologies that are similar or superior to our technology.

We have not received any claims that our products or processes infringe on the proprietary rights of third parties and we have no assurance that third parties will not assert such claims against us with respect to our existing and future products. Litigation to determine the validity of any third party's claims could result in significant expense and divert the efforts of our technical and management personnel, whether or not such litigation is determined in our favor. In the event of an adverse result of any such litigation, we could be required to expend significant resources to develop non-infringing technology or to obtain licenses for, and pay royalties on the use of, the technology subject to the litigation. We have no assurance that we would be successful in such development or that any such license would be available on commercially reasonable terms.

On October 4, 2006, we received an English translation of an action filed on June 9, 2006 in the South Korean Intellectual Property Office by MC Lab Corporation. MC Lab Corporation sought invalidation of our South Korean gemstone patent on the basis of an alleged lack of inventiveness as compared to certain prior art. In September 2007, the petition by MC Lab Corporation to invalidate our patent was dismissed. On September 29, 2007, MC Lab Corporation filed a Notice of Appeal with the Patent Court. On April 15, 2008, the first court hearing of the appeal was held and several other hearings have been held since that time. A final hearing was held on October 30, 2008, and on December 11, 2008, the South Korean Patent Court ruled our patent to be invalid. On December 29, 2008, MC Lab Corporation contacted us regarding an offer of settlement. On January 2, 2009, we filed a Notice of Appeal to the South Korean Supreme Court. The appeal is currently stayed pending efforts to settle the matter outside of the court system. Management believes that the South Korean patent was properly issued and we will vigorously appeal the decision of the South Korean Patent Court if a settlement cannot be reached. We do not presently have material sales in South Korea and the decision will not be legally binding in any other jurisdiction.

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Manufacturing

The production of moissanite jewels includes the following steps:

growing SiC crystals;

designing shapes with proportions unique to moissanite jewels;

cutting crystals that will yield jewels of an approximate carat weight and millimeter size;

faceting jewels; and

inspecting, sorting and grading faceted jewels.

Growth of SiC Crystals. Cree has grown the majority of our SiC crystals in accordance with the terms of the Exclusive Supply Agreement. We routinely evaluate the yield and quality of saleable moissanite jewels from SiC crystals. The yield of saleable jewels from each crystal is the most significant factor affecting the volume and cost of moissanite jewels available for sale. Yield is dependent on the quality of the crystals. Variations in crystal quality can adversely affect our gross margin percentage.

Designing Shapes with Proportions Unique to Moissanite Jewels. Maximizing the light reflected from a faceted moissanite jewel requires the design of shapes with unique proportions and angles. We create proprietary designs, using computer modeling, to display the maximum light reflection based on the optical properties (i.e., refractive index, dispersion and luster) of moissanite jewels. The first shape we developed applying these computer models was a moissanite version (unique facet angles and proportions) of the standard round brilliant cut. More recently, we have designed modified square brilliant and modified round brilliant shapes. We believe these proprietary designs are the basis for the superior optical performance quality observed in faceted moissanite jewels.

Faceting Moissanite Jewels. Faceting is a critical stage in obtaining quality jewels. The techniques and skills used in faceting moissanite jewels differ somewhat from those used in faceting diamonds and other gemstones. We currently outsource the faceting of our moissanite jewels, other than faceting for small special orders or research and product development purposes which we conduct internally. During 2009, we intend to continue to outsource faceting services to our existing suppliers, and we will depend on their ability to provide an adequate quantity of quality faceted moissanite jewels. We cannot be sure that they will be able to continue to produce our quality specifications for faceting and meet our quantity and time requirements. Currently, we have three suppliers of volume faceting services, all of which are located in Asia, and we have been satisfied with the capabilities and performance of each of these suppliers. The majority of our faceting services are provided by John M. Bachman, Inc. (JMB), as discussed below.

In 1997, we entered into a multi-year agreement with JMB. In August 2008, to eliminate our monthly minimum commitments for faceting services, we exercised our option to terminate the agreement with JMB. Although the agreement with JMB was terminated effective October 2008, we are currently operating with JMB on an as needed basis. We anticipate our needs for faceting services to be very limited in 2009 due to our large inventory position.

Inspection, Sorting and Grading. Once faceted moissanite jewels are returned to us, we inspect, sort and grade them. During this stage, specially trained personnel individually examine and grade each moissanite jewel against certain quality parameters. In addition, we process a sample of each batch through an image analyzer for exacting quality control. This phase of manufacturing is relatively labor-intensive and requires skills not readily available in the general work force. In the future, we may elect to outsource certain portions of this stage of the manufacturing process to an independent third party. We will require third parties to which we may outsource these processes to adhere to our rigorous quality control and monitoring standards. We have no assurance that we will be able to hire or retain sufficient numbers of appropriately skilled personnel for this phase of manufacturing or find and enter into acceptable agreements with third party vendors or that such vendors will be able to provide accurate inspection, sorting and grading services on a timely basis.

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Marketing and Distribution

Marketing

Domestic. Historically, the primary target consumer market for moissanite jewelry has been the self-purchasing woman. However, beginning in 2008 and continuing in 2009, Charles & Colvard has expanded and broadened its marketing message beyond the self-purchasing woman to include more segments of the larger marketplace of jewelry for every occasion including bridal, anniversary and gift-giving.

The global economy continues to worsen and consumer demand for luxury items, including jewelry, has been significantly reduced. The market is seeing an increase in promotion of man-made diamonds as well as a trend of blending fine and fashion jewelry with perceived high value cubic zirconia. We believe that moissanite has a quality and value proposition to the consumer which is unique in the marketplace. By broadening our marketing message, we intend to reach a larger market audience to help increase sales and increase moissanite's overall awareness levels.

As many retailers currently have an excess of in-case inventory, marketing efforts designed to increase sell-through are extremely important. The market is especially challenging as consolidation pressures on both department store retailers and jewelry store retailers are intensifying.

Consumer Advertising. As a result of the economic downturn, 2008 saw a reduced cooperative marketing effort from both our manufacturers and their retail partners. In early 2008, we launched the educational website www.whatismoissanite.com. This comprehensive, interactive website allows visitors to learn about moissanite - its history, comparison of the jewel's properties with other jewels, and its features portrayed by streaming video with expert commentary. The website also serves as a related hotlink or microsite that lives on the retailer's moissanite landing page and allows the consumer to learn more without leaving the retailer's website.

Charles & Colvard also created two programs which recognized women in 2008. The first program, Moissanite Milestone Moments, an online contest, is a viral entry campaign allowing women to tell their stories about triumph over hardship and building a valuable community of women who share an interest in moissanite. The second program, Women of Brilliant Achievement™, recognizes the outstanding and inspirational accomplishments of women through perseverance, professional mentoring, excellence and enterprise. Five outstanding women were named Honorees under this program during 2008.

In the latter half of 2008, we launched the Charles & Colvard Authorized Internet Retailer (AIR) program housed on www.moissanite.com. AIR is a joint effort between Charles & Colvard and select e-commerce websites that provides moissanite customers with a professional moissanite internet shopping experience. All AIR participants are pre-screened, have met program criteria and are sponsored by a Charles & Colvard manufacturer or distributor.

Prior to 2008, Charles & Colvard had traditionally used print advertising as the marketing medium of choice. The marketing message was delivered through fashion, lifestyle, and consumer magazine advertisements. Moissanite special events had been augmented by regional and local newspaper advertising, and we supported national newspaper advertising with our manufacturers and retailers through our cooperative advertising program. However, due to declining readership of print media and reduced effectiveness, we plan to re-evaluate our use of print advertising in 2009.

Public Relations. Public relations activities can be an important component of our marketing and are integral to supporting the launch of new moissanite retailers and independent jewelers. We currently plan to focus such efforts in 2009 on increasing moissanite awareness, interest and purchase intent at the consumer level by generating editorial coverage and moissanite jewelry product placement.

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Moissanite Awareness. Research conducted by independent sources from January 2006 to January 2008 indicated that moissanite awareness among U.S. women had increased and then maintained its level (from 7.8% in January 2006, peaking at 10.5% in January 2007 and remaining constant a year later in January 2008). Management currently does not plan to conduct the moissanite awareness study in 2009 as it focuses efforts on addressing our current marketing and distribution methods.

Marketing to the Trade. From 2004 through 2008, Charles & Colvard's marketing message to the jewelry trade positioned moissanite as a new jewel and jewelry category that could provide an additional opportunity to build incremental revenue and profits. Over the last three years, Charles & Colvard augmented this message by partnering with National Jeweler magazine and our manufacturers to create a Moissanite Supplement. This 28-page-plus yearly insert provides the trade industry an in-depth publication that includes: education about the jewel; elaboration of the overall business opportunity; profiles and interviews of female purchasers; industry research and statistics from current retailers selling moissanite, and successful moissanite retail jewelry trade testimonials. As we proceed with a broader message, we currently plan to shift from trade marketing to an increased emphasis on marketing to the consumer to motivate consumer purchases.

International. During 2008, Charles & Colvard concentrated on global congruency of the marketing message of moissanite. Most of our international distributors are still educating their clients and consumers about our jewel. To help aid our distributors in their marketing efforts, we committed to continue international trade advertising in both Diamond World and Gem and Jewellery magazines through the first half of 2009. Distributors who adhere to Charles & Colvard's branding guidelines have been eligible for cooperative advertising and marketing allowances. Recognizing that each distributor's approach to market can be as unique as the culture in which they live, we are relaxing our branding guidelines to accommodate more flexibility in order to be better accepted in more markets. We continue to educate, work with and support our distributors as they develop advertising, marketing and public relations campaigns that prove to be successful in their markets.

Trade Shows. Charles & Colvard's participation in leading jewelry trade shows, worldwide, assisted the company in extending its outreach to customers as the economic climate and corporate structure continued to change. Whether Charles & Colvard engaged as a sponsor, an exhibitor or a participant assisting manufacturing clients, it was apparent that our customers appreciated our efforts to connect personally with them. However, because of the continued precipitous decline in jewelry industry economic conditions, management currently does not plan to participate in any 2009 trade shows.

Sponsorships. Charles & Colvard continues to support global trade organizations like CIBJO, The World Jewellery Confederation, which encourages harmonization, promotes international cooperation in the jewelry industry, and considers issues which concern the trade worldwide. Charles & Colvard also partnered with the JVC (Jewelers Vigilance Committee) during 2008. The JVC is the industry's guardian of ethics and integrity, and together we produced a consumer brochure titled *Buying Gemstones and Jewels with Confidence* which continues to educate consumers regarding the differences between diamond, moissanite and cubic zirconia.

Distribution

According to preliminary estimates provided by the International Diamond Exchange, the consumer market in 2008 for jewelry sales in the United States was approximately \$65 billion.

Domestic. Traditionally, consumers have purchased jewelry through independent and chain jewelry stores and department stores. More recently, major shifts are occurring in the retail environment for jewelry. Traditional sales channels are contracting (e.g. independent jewelry stores, mall-based chain jewelers, mid-market department stores) while other channels, such as e-commerce, wholesale shopping clubs, and discounters such as Wal-Mart are expanding their presence in jewelry. Traditional retailers have consolidated by closing non-productive locations and some have declared bankruptcy (Whitehall

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Jewelers, Boscov's, Gottschalks, Mervyn's). At the manufacturing level in the United States, the shift of jewelry production and design to low-cost markets such as China and India has created dramatic consolidation, with remaining manufacturers struggling to survive or create a competitive advantage. Today, moissanite jewelry is sold to consumers through a broad range of channels: single and multiple-location independent jewelry stores, jewelry store chains, online, TV shopping channels, department stores, and catalogs.

In May 2000, in order to more rapidly expand the distribution of moissanite, we modified our distribution model from selling moissanite jewels directly to independent retail jewelers to allowing independent retail jewelers to access loose moissanite jewels and moissanite jewelry through two established jewelry distributors, Stuller and Rio Grande. Additionally, we have entered into arrangements with several jewelry manufacturers that design and manufacture lines of jewelry containing moissanite jewels. Jewelry retailers have access to loose moissanite jewels from Stuller and Rio Grande and to jewelry containing moissanite jewels from Stuller, SAI, Richline Group, and other jewelry manufacturers.

We believe that moissanite jewels provide retailers with an opportunity to earn a profit margin from the moissanite jewelry category that compares favorably with other jewelry products and allows retailers to distinguish their product lines from other jewelers in the highly competitive retail jewelry market. We also believe moissanite jewelry provides retailers with an opportunity to capture more female consumers, as warranty card data indicates that approximately 75% of moissanite purchasers are female. We also see a larger opportunity with bridal, gift giving and the socially conscious consumer, and we will attempt to build our market share by addressing these broadened market segments. We believe moissanite jewelry margins create incentives for retailers to maximize their sales and promotional efforts, which may result in additional consumer demand for our moissanite jewels.

Currently, however, Charles & Colvard has limited influence through the supply chain. Our current business model of supplying jewels to finished jewelry manufacturers and distributors has proven to create hurdles to effective program and business management. These obstacles include credit risk in a consolidating industry, role definition issues, conflict of interest issues (by manufacturers) with other lines offered, costs incurred due to returns and markdowns, lack of transparency to retailers and consumer, and loss of design control of the finished jewelry item.

The quality, design and workmanship of the settings and mountings chosen by distributors, manufacturers, and retailers affects consumer perception and acceptance of our jewel, and our control over these elements is currently limited. We continue to evaluate the most appropriate structure for distribution in North America and may, in certain circumstances, enter into direct distribution arrangements, including arrangements with selected department stores, specialty jewelry chains and distribution channels such as moissanite retail stores, catalog sales or Internet sales.

Retailers were in a consolidation mode in 2008, which reduced the number of stores carrying moissanite jewelry. The door count reduction was based on factors that included retailers closing all doors or closing certain locations to improve their overall financial performance. There are six retailers as of December 31, 2008 having more than 50 store locations that currently sell moissanite jewelry: Kohl's, JCPenney, Finlay, Helzberg, Belk and Army Air Force Exchange Systems. We do anticipate there may be some further reduction in store or door counts for the same reason mentioned above.

Our four largest customers during 2008 were Stuller, Reeves Park, Richline Group, and SAI. In November 2008, we terminated our manufacturing agreement with Reeves Park due to Reeves Park's repeated failure to make timely payments for shipped moissanite. We are currently working with retailers previously supplied by Reeves Park to establish relationships either directly with Charles & Colvard or with new manufacturers. While we believe our current relationships with our largest customers are good, and alternate manufacturers and distributors are available to serve their customer base, a loss of these customers could cause a material adverse effect on our results of operations in a particular period. We expect that, at least over the short term, we will remain dependent on our ability and that of our manufacturing customers to maintain and enhance their retail programs.

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We will continue to support trunk show events that will enable us to introduce moissanite jewelry at new points of distribution and improve sales at existing retailers. We seek to participate with retailers in training their sales and marketing personnel in moissanite sales positioning and strategies and in working with them to create focused advertising and promotional efforts to publicize trunk shows and other special sales events at select store locations. In addition, to facilitate new or expanded distribution, we have allowed inventory to be placed in stores on a consignment basis. As part of the settlement agreement we entered into with Reeves Park in January 2009, we have assumed operating responsibility for the 2009 schedule of trunk shows for JCPenney.

We are in the process of considering possible changes to our current pricing structures to our customers which may more closely reflect the cost economics of servicing different categories of customers. We are assessing possible marketing and sales programs that may help us achieve increased sales with an ancillary goal of reducing our currently high inventory levels.

We generally have contracts and agreements with our distributors and manufacturers with some variations in terms and with variations in duration. During the latter part of 2008 and the early part of 2009, we have permitted some of these agreements to expire, and we are in the process of negotiating new agreements with some of our distributors and manufacturers. We currently intend to evolve these agreements to a more standardized format.

International. We have continued to invest in certain international markets that we believe have the most potential with respect to acceptance and sales of the moissanite jewel. During 2008, foreign sales were 29% of our total sales. More details on our financial information by geographic area are included in Note 1 to our consolidated financial statements included in Item 8, Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

In October 2000, we established a wholly-owned subsidiary in Hong Kong, Charles & Colvard (HK) Ltd., for the purpose of gaining better access to the Far Eastern markets. To enhance our presence in this market, we established a Charles & Colvard controlled company in China in August 2003 named Guangzhou Charles & Colvard Trading Limited. During 2008, the Company closed the operations of both its Hong Kong subsidiary and the controlled company in China in an effort to contain costs.

We currently have distributors for Charles & Colvard jewels covering substantially all of Western Europe, Australia, India and certain countries in Southeast Asia and the Middle East. We have approximately 30 international distributors and may increase this number. All sales to international customers are denominated in U.S. dollars. Export sales aggregated approximately \$4.4 million, \$5.0 million, and \$4.7 million in 2008, 2007, and 2006, respectively. It should be noted that a portion of our international sales is due to jewels sold internationally that are re-imported to North American retailers.

We are subject to the risks associated with doing business in international distribution channels. Please refer to Item 1A, Risk Factors of this Annual Report on Form 10-K for more details on these risks.

Seasonality

Retail sales of moissanite jewelry are significantly greater during the Christmas and holiday season. Because we primarily sell our jewels direct to manufacturers and distributors, our sales to support the holiday season largely take place during the third and beginning of the fourth calendar quarters, depending on the level of advance planning and production our customers undertake. The second half of each year accounted for 52%, 52%, and 59% of our sales during the years ended December 31, 2008, 2007 and 2006, respectively. The effect of seasonality on our business depends on the timing of orders we receive to support new or expanded distribution and the level of inventory maintained by our customers, which could significantly affect our sales in a given quarter, regardless of seasonality.

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Due to the recent and current economic downturn and previously large initial stocking quantities to support previously expanding distribution, both our manufacturing customers and the retailers have had significant inventory levels over the past few years, which have negatively impacted our sales numbers in those periods.

Working Capital Practices

Our primary source of working capital is cash on hand and cash generated by operations. The current status of our working capital is discussed in more detail in the **Liquidity and Capital Resources** section of Item 7, **Management's Discussion of Financial Condition and Results of Operations** of this Annual Report on Form 10-K.

Because our supply agreements for raw material purchases restrict our suppliers in the sale of SiC crystals for jewelry applications to selling only to us, our suppliers negotiate minimum purchase commitments with us that may result in inventories that are higher than we might otherwise maintain. Our current inventory levels are sufficient to enable us to respond promptly to customer orders and we currently have no material order backlogs.

Our standard payment terms are generally between 30 and 60 days for jewel distributors and generally between 60 to 120 days for jewelry manufacturers. The Company extends credit to its customers based upon a number of factors, including an evaluation of the customer's credit history, the customer's payment history with the Company, the customer's reputation in the trade and an evaluation of the customer's opportunity to introduce our jewel to new or expanded markets. We believe that our payment terms are consistent with the payment terms offered in the jewelry industry. We are hopeful that we will be able to negotiate and implement changes to our agreements and to our credit and interest charge policies that may enable us to achieve lower levels of accounts receivables going forward.

The Company's return policy is that jewels can only be returned for credit within 30 days of shipment and must be returned for a valid reason (e.g. quality problems or a shipment of the wrong jewels). Some customers, however, have a contractual right to return a certain percentage of sales for any reason for specific periods of time. We have established an allowance for returns based on our historical return rate, which takes into account any contractual return privileges granted to our customers. Periodically, the Company ships jewels to customers on **memo** terms. For shipments on **memo** terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. The Company does not recognize revenue on these transactions until the earlier of (1) the customer informing the Company that it will keep or has sold the jewels or (2) the expiration of the memo period if the jewels are not returned. Jewels shipped to customers on **memo** are classified as inventory on consignment on the Company's consolidated balance sheets.

Competition

Gemstone materials can be grouped into three types:

natural gemstone, which is found in nature;

synthetic gemstone, which has the same chemical composition and essentially the same physical and optical characteristics of natural gemstone but is created in a lab; and

simulated or substitute material, which is similar in appearance to natural gemstone but does not have the same chemical composition nor physical or optical characteristics.

Our moissanite jewel, which is positioned as a unique new jewel, may compete with fine gemstones such as ruby, sapphire, emerald and tanzanite as well as with natural, synthetic, and treated diamonds and existing synthetic gemstones such as synthetic cubic zirconia. We may also face competition from synthetic diamonds, synthetic diamond films and other sources of synthetic moissanite not presently available in qualities, sizes and volumes suitable for use as gemstones. Many of the suppliers of diamonds and other fine gemstones, as well as the suppliers of synthetic gemstones, have substantially greater financial, technical, manufacturing and marketing resources and greater access to distribution channels than we do.

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Despite our efforts to market our jewel as a unique new jewel, the diamond industry has established an overwhelming level of consumer desirability and acceptance which has been iconicized by the Diamonds are Forever diamond marketing campaign. Our jewel, despite our efforts to differentiate it from diamond by virtue of its different material composition and its optical characteristics of brilliance and fire that are superior to diamond, still resembles diamond in the eyes of consumers. As a result, moissanite is still viewed by some consumers as a diamond alternative or a diamond substitute.

The worldwide market for large, uncut high-quality natural diamonds is significantly consolidated and controlled by DeBeers (headquartered in London), Alrosa (Russia), Rio Tinto (Australia) and BHP (Canada). These companies have a major impact on the worldwide supply and pricing of natural diamonds at both the wholesale and retail levels. Diamond producers may undertake additional marketing or other activities designed to protect the diamond jewelry market against sales erosion from consumer acceptance of moissanite jewels.

We may also face competition from treated and synthetic diamonds. Treated diamonds, which are natural diamonds with imperfections or flaws that have been altered in some manner to enhance their appearance, have been available for the past 20 years in the jewelry industry and are generally less expensive than diamonds of similar size, cut and color which have not been altered. Synthetic diamonds are also available in the marketplace and are produced for jewelry applications available to consumers, however, most synthetic diamonds that are sold today are in the yellow color range. Although we believe that colorless gemstone-quality synthetic and treated diamonds presently cannot be produced at prices competitive with those currently offered for our near-colorless moissanite jewels, there can be no assurances that such competitive prices cannot be achieved in the future by the producers of either or both of synthetic and treated diamonds. The primary producers of synthetic diamonds used for industrial applications are DeBeers, Sumitomo and GE. There are also a number of Russian producers of synthetic diamonds for industrial uses. In addition, companies such as Gemesis Corporation, Chatham and Apollo Diamonds are, we understand, synthesizing diamonds, in limited quantities, limited carat sizes and in limited ranges of color. Synthetic diamond films can be grown at commercially viable prices in thicknesses that can be applied to various surfaces such as other synthetic materials.

Although we believe that our products have a proprietary position, we could face competition from other companies that develop competing SiC technologies. Some of these technologies could be developed by producers of SiC used for other industrial applications. Manufacturers of industrial SiC products include The Carborundum Corporation (currently for abrasive uses), and Cree, Siemens AG, Norstel, Bridgestone ABB, Dow Chemical, SiC Crystal AG, and Northrop Grumman Corporation (currently for semiconductor uses). We believe that Cree and Norstel are currently the only suppliers of SiC crystals in colors, sizes and volumes that are currently suitable for gemstone applications. It is possible, however, that these or other producers of SiC could develop SiC crystals suitable for gemstone applications and produce moissanite jewels until we could obtain judicial enforcement of our patent rights. It is also possible that such competition could emerge in geographic territories where we might not have adequate patent protection.

We may also face competition from synthetic cubic zirconia, the principal existing diamond simulant and, to a lesser degree, other synthetic gemstones. The largest producer of synthetic cubic zirconia gemstones is Signity. In addition, there are a significant number of other producers of jewelry containing synthetic gemstones. Three of the largest retailers of synthetic cubic zirconia jewelry in the United States are QVC, HSN and Wal-Mart. Some of the major retailers of synthetic cubic zirconia, including QVC, have captive manufacturing divisions that produce synthetic cubic zirconia jewelry. These producers and sellers may see their markets being eroded by the introduction of our moissanite jewels. We believe that the substantially lower price of these products is the primary basis upon which they will compete with our moissanite jewels.

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We intend to compete primarily on the basis that the unique qualities of our moissanite jewels are distinct from all other jewels based on their fire, brilliance, luster, durability and rarity. In addition, we believe that the Charles & Colvard created Moissanite brand, which is being developed pursuant to our marketing program, may create a long-term competitive advantage for our products. Additionally, we believe that moissanite jewels have a significant cost advantage over other fine gemstones, especially in the one-carat size and larger. Our competitive success depends, in part, on the following:

the increasing interest and demand for moissanite jewelry at the consumer level;

the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers and designers to market and promote Charles & Colvard moissanite jewels to the retail jewelry trade;

the willingness of distributors, retailers and others in the channel of distribution to purchase loose Charles & Colvard moissanite jewels and the willingness of manufacturers, designers and retail jewelers to undertake setting of the loose jewels;

the ability of manufacturers, designers and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;

the ability of jewelry manufacturers and retail jewelers to set loose Charles & Colvard moissanite jewels in jewelry with high quality workmanship;

the ability of retail jewelers to effectively market and sell jewelry containing Charles & Colvard created Moissanite to consumers;

Government Regulation

Our products are subject to regulation by the Federal Trade Commission (FTC). The FTC has issued regulations and guidelines governing the marketing of synthetic gemstones and other gemstones similar to diamond that require such gemstones to be clearly identified in any promotional or marketing materials. While we intend to comply fully with all FTC regulations, we cannot be sure that the FTC or a competitor will not challenge our promotional or marketing activities. Such a challenge could result in significant expense and divert the efforts of our management, whether or not such challenge is resolved in our favor. If our actions were found to be in violation of FTC regulations, we could be forced to suspend marketing of our products and could incur significant expenses in developing new marketing strategies and materials that would not violate FTC regulations.

Employees

At February 28, 2009, we had 33 employees. We believe that our future prospects will depend, in part, on our ability to retain our current employees and to obtain additional management, marketing, sales, manufacturing, scientific and technical personnel. None of our employees are represented by a labor union. We believe that our employee relations are good.

Available Information

Our Internet website is www.moissanite.com or www.charlesandcolvard.com. The information contained on, or that can be accessed through, our website is not incorporated by reference into this annual report on Form 10-K. We have included our website address as a factual reference and do not intend it to serve as an active link to our website. We make available free of charge through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

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ITEM 1A. RISK FACTORS

In addition to the other information in this Form 10-K, you should carefully consider the following important factors that in some cases have affected, and in the future could affect, our actual performance and results and could cause our actual results of operations to differ materially from those expressed in any of our forward-looking statements.

Our business and our results of operations could be materially adversely affected as a result of general economic and market conditions, including the current economic crisis. Global financial markets have recently been experiencing extreme disruptions, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increases in unemployment rates, and uncertainty about economic stability. We are unable to predict the likely duration and severity of the current disruptions in the financial markets and the adverse global economic conditions, and if the current uncertainty continues or economic conditions further deteriorate, our business and results of operations could be materially and adversely affected. The consequences of such adverse effects could include interruptions or delays in our suppliers' performance of our contracts, reductions and delays in customer purchases, delays in or the inability of customers to obtain financing to purchase our products, and bankruptcy of customers and/or suppliers.

Luxury products, such as fine jewelry, are discretionary purchases for consumers. The recent reduction in consumer discretionary spending, largely attributed to the conditions described above, has affected our industry more significantly than many other industries. Consumer discretionary spending is strongly affected by economic factors outside our control, including the condition of financial markets, consumer credit availability, prevailing interest rates, energy costs, employment levels, salary levels and tax rates. A continued reduction in discretionary consumer spending could have a material adverse affect on our business and financial condition.

A further decline in sales could continue to have a material adverse effect on us and our results of operations. Our annual sales declined from \$40.7 million in 2006 to \$27.8 million in 2007 to \$14.7 million in 2008. A further decline in sales could continue to adversely affect our relationships with our suppliers and distributors and adversely affect our ability to retain key employees. Due to the large inventory position we currently have, we reduced our manufacturing levels in 2008 and expect further reductions in future years until our inventory position is more in line with our sales. Our 2008 raw material purchases were significantly reduced and we expect further reductions in our purchases in 2009. We have no assurance that the quality of the raw material crystals we receive will not be affected by the reduced purchase levels or that our raw material suppliers will be able to timely deliver increased quantities to us should we require a return to a higher level of purchases. Additionally, due to our reduced and deferred purchase commitments, we have experienced significant price increases that will likely reduce future gross margin percentages. The reduction in raw material purchases could have a negative long-term impact on our relationships with our suppliers.

In addition, we significantly reduced the amount of jewels we faceted during 2008 and expect further reductions in 2009. We believe our primary supplier of faceting services, JMB, is substantially dependent on our business to fund its operations. To eliminate our minimum monthly commitments for faceting services, we terminated our agreement with JMB in 2008, but we are currently operating with JMB on an as needed basis. We can not be assured that JMB will be able to continue in business with our reduced faceting levels. We have no assurance that other suppliers of faceting services could meet our demand on a timely basis or that we will not experience increased prices for our faceting services.

Our future financial performance depends upon increased consumer acceptance and growth of sales of our products. We believe that many retail jewelers and most consumers are not generally aware of the existence and attributes of moissanite jewels. The market for moissanite jewels among retail jewelers and consumers is in the early stages of development. Total moissanite jewelry retail sales during the year ended December 31, 2008 were less than 1% of the total jewelry market. The degree of future market acceptance and demand are subject to a significant amount of uncertainty. Our future financial

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performance will depend upon greater consumer acceptance of moissanite jewels as distinct from all other jewels based on their fire, brilliance, luster, durability and rarity. In addition, consumer acceptance may be affected by retail jewelers and jewelry manufacturers acceptance of moissanite jewels. We primarily market loose jewels which jewelry distributors, manufacturers and retailers set in jewelry and in turn distribute or sell to consumers.

The quality, design and workmanship of the jewelry settings selected by retail jewelers, which is not within our control, could affect consumers perception and acceptance of our jewels. Thus, our future financial performance may be affected by:

the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers and designers to market and promote moissanite jewels to the retail jewelry trade;

the willingness of distributors, retailers and others in the channel of distribution to purchase loose moissanite jewels and the willingness of manufacturers, designers and retail jewelers to undertake setting of the loose jewels;

the ability of manufacturers, designers and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;

the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in jewelry with high quality workmanship; and

the ability of retail jewelers to effectively market and sell moissanite jewelry to consumers.

If our products do not receive greater market acceptance, our business, operating results and financial condition would be materially and adversely affected.

We expect to remain dependent upon Cree for the supply of most of our SiC crystals for the foreseeable future. If we are unable to obtain sufficient, high quality SiC crystals from Cree, and we have a significant increase in demand for our jewel, then we may not be able to meet that demand. Cree has certain proprietary rights relating to its process for growing large single crystals of SiC and its process for growing near-colorless SiC crystals. Under our Exclusive Supply Agreement with Cree, we are obligated to buy from Cree, and Cree is obligated to sell to us, at least 50%, by dollar volume, of our requirements for SiC material for the production of gemstones in each calendar quarter through June 2015. In February 2005, we entered into an exclusive supply agreement with Norstel, which was amended in April 2008 and October 2008. Our ability to decrease our reliance on Cree, in the short term, is contingent on Norstel being capable of producing quality crystals in higher quantities than it has in the past. Norstel provided less than 1% of our raw material purchases in 2006 and 2007 and increased deliveries in 2008 to 21% of our total raw material purchases. Although we expect purchases from Norstel during 2009 to continue to increase as a percentage of total purchases, we remain dependent on Cree for most of our supply of lab-grown SiC crystals.

While Cree has improved its production processes and is currently producing SiC crystals sufficient to meet our requirements, we have experienced difficulties in the past in obtaining crystals from Cree in the quality, sizes and volumes that we desired. There can be no assurance that Cree will be able to continue to produce and supply us with SiC crystals of sufficient quality, sizes and volumes that we desire nor that we will successfully negotiate purchase commitments that enable us to manage our inventories and raw material costs effectively. In addition, although Norstel represents a potential additional source of supply, Norstel has not yet proven to have the capability to produce significant quantities of SiC crystals of suitable quality and sizes, and there can be no assurance that it will ever develop these capabilities.

For the sale of our jewels in North America, we are currently substantially dependent on Stuller Settings, Inc. and a limited number of other distributors and jewelry manufacturers. We anticipate that the majority of the moissanite jewels that we sell in North America will be distributed through Stuller and a limited number of other manufacturers and distributors, and therefore, we are substantially dependent upon these companies for distribution of moissanite jewels in North America. During the year ended December 31, 2008, Stuller accounted for 21% of total sales. Our three other largest domestic customers collectively accounted for 27% of total sales. In late 2007, we terminated our manufacturing agreement

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with K&G Creations (one of our largest customers in 2007) and in 2008 we terminated our manufacturing agreement with Reeves Park (one of our largest customers in 2007 and 2008). This disruption in our distribution model was significant and there can be no assurance that retailers previously supplied by K&G Creations and Reeves Park will continue to sell moissanite jewelry.

The financial difficulties or insolvency of one or more of our major customers could adversely affect results. We are subject to a concentration of credit risk amongst our major customers and a default by any of these customers on their debts to us could have a material adverse affect on our financial position. Future sales and our ability to collect accounts receivable depend, in part, on the financial strength of customers. We estimate an allowance for accounts for which collectibility is at risk and this allowance adversely impacts profitability. In the event customers experience greater than anticipated financial difficulties or insolvency, profitability would be expected to be adversely impacted by the Company's failure to collect accounts receivable in excess of the estimated allowance. Given the current economic environment, constrained access to capital and general market contractions may heighten our exposure of customer default.

We are subject to certain risks due to our international distribution channels and vendors. We currently have approximately 30 international distributors for moissanite jewels covering substantially all of Western Europe, Australia, India, and certain countries in Southeast Asia and the Middle East. Our long-term strategy is to expand the number of international markets for our products. In addition, we expect to continue to use certain companies based outside the United States to facet our moissanite jewels. Due to our reliance on development of foreign markets and use of foreign vendors, we are subject to the risks of conducting business outside of the United States. These risks include the following:

the adverse effects on United States-based companies operating in foreign markets that might result from war, terrorism, changes in diplomatic, trade or business relationships or other political, social, religious or economic instability;

the continuing adverse economic effects of the global financial crisis;

unexpected changes in, or impositions of, legislative or regulatory requirements;

delays resulting from difficulty in obtaining export licenses;

tariffs and other trade barriers and restrictions; and

the burdens of complying with a variety of foreign laws and other factors beyond our control.

Additionally, while the majority of our foreign transactions are denominated in U.S. dollars, foreign currency fluctuations could impact demand for our products or the ability of our foreign suppliers to continue to perform. Further, some of these distributors operate relatively small businesses and may not have the financial stability to assure their continuing presence in their markets. There can be no assurance that the foregoing factors will not adversely affect our operations in the future or require us to modify our anticipated business practices.

We rely upon our ability to protect our intellectual property. We have United States product and method patents for moissanite jewels under which we believe that we have broad, exclusive rights to manufacture, use and sell moissanite jewels in the United States. We have these same patents in a number of foreign jurisdictions. We believe that these patents create substantial technological barriers to our potential competitors.

At the present time, we are also dependent on Cree's technology for the production of SiC crystals. Cree is exclusively licensed to use a patent concerning a process for growing large single crystals of SiC, has certain patents of its own relating to growth of large single crystals of SiC and has a patent for a process for growing near-colorless SiC crystals. If Norstel becomes a significant additional source of supply, we will also become dependent on its technology.

There can be no assurance that any patents issued to or licensed by or to us, Cree or Norstel will provide any significant commercial protection, or that we, Cree or Norstel will have sufficient resources to prosecute our respective patents or that any patents will be upheld by a court should we, or our suppliers

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seek to enforce our respective rights against an infringer. The existence of valid patents does not prevent other companies from independently developing competing technologies. Existing producers of SiC crystals or others may refine existing processes for growing SiC crystals or develop new technologies for growing large single crystals of SiC or colorless SiC crystals in a manner that does not infringe patents owned or licensed by us, Cree or Norstel. In addition, existing producers of SiC crystals, existing producers of other synthetic or natural gemstones or other parties may develop new technologies for producing moissanite jewels in a manner that does not infringe patents owned or licensed by us, Cree or Norstel.

As a result of the foregoing factors, existing and potential competitors may be able to develop products that are competitive with or superior to our products, and such competition could have a material adverse effect on our business, operating results and financial condition.

Governmental regulation and oversight might adversely impact our operations. We are subject to governmental regulations in the manufacture and sale of moissanite jewels. In particular, the Federal Trade Commission has the power to restrict the offer and sale of products that could deceive or have the tendency or effect of misleading or deceiving purchasers or prospective purchasers with regard to its type, kind, quality, character, origin or other characteristics. We may be under close scrutiny both by governmental agencies and by competitors in the gemstone industry, any of which may challenge our promotion and marketing of our moissanite jewel products. If our production or marketing of moissanite jewels is challenged by governmental agencies or competitors, or if regulations are issued that restrict our ability to market our products, our business, operating results and financial condition could be materially adversely affected.

Our reputation among jewelers and consumers could be damaged if low-quality gemstones or synthetics are marketed as moissanite. It is possible that low-quality gemstones or other synthetics could be falsely marketed by others as moissanite. The sale of low-quality products as moissanite could damage our ability to foster the perception of moissanite as a unique jewel that compares favorably to other fine gemstones like diamond, ruby and emerald. This could damage our reputation among retail jewelers and consumers and result in a loss of consumer confidence in our products. The introduction of low-quality imitation moissanite jewels and our inability to limit the adverse effects thereof could have a material adverse effect on our business, operating results and financial condition.

We face competition in the worldwide jewelry industry. The jewelry industry is highly competitive and we compete with numerous other jewelry products, including diamonds, cubic zirconia, and watches, among others. In addition, despite the positioning of moissanite as a unique jewel, we face competition from treated diamonds, synthetic diamonds, and companies developing other synthetic jewelry technologies. A substantial number of companies supply products to the jewelry industry, many of which we believe have greater financial resources than we do. Competitors could develop new or improved technologies that may render the pricing point for moissanite noncompetitive, which would have an adverse effect on our business, results of operations, and financial condition.

Sales of moissanite jewelry could be dependent upon the pricing of precious metals, which is beyond our control. Any increases in the market price of precious metals (primarily gold) could affect the pricing and sales of jewelry incorporating moissanite jewels. The majority of price increases in precious metals are passed on to the consumer in the form of higher prices for finished jewelry. These higher prices could have a negative impact on the sell-through of moissanite jewelry at the retail level. From the beginning of 2006 to the end of 2008, the price of gold has increased significantly (approximately 60%), resulting in higher retail price points for gold jewelry. This has had a negative impact on both sales of moissanite jewelry and the jewelry industry as a whole. We currently encourage our customers to set moissanite jewels in jewelry with a gold quality of 14 Karat or higher or in Platinum. Due to high gold prices, we are currently reassessing this strategy and relaxing our Brand Identity Guidelines to allow our customers to set moissanite jewels in settings made from other materials, including silver.

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Our common stock is currently subject to potential delisting from the NASDAQ Global Select Market. On August 18, 2008, we received a notice from the Listing Qualifications division of The NASDAQ Stock Market LLC (NASDAQ) indicating that our common stock is subject to potential delisting from the NASDAQ Global Select Market because, for the preceding 30 consecutive business days, the bid price of the Company's common stock had closed below the minimum \$1.00 closing bid price requirement for continued inclusion on the NASDAQ Global Select Market. As a result of the recent extraordinary market conditions, NASDAQ has temporarily suspended its enforcement of the minimum \$1.00 closing bid price requirement and announced that it will not take any action to delist any security failing to meet the bid price requirement between October 16, 2008 and July 19, 2009. As a result of the temporary suspension, we currently have until November 18, 2009 to regain compliance with the minimum \$1.00 closing bid price requirement for continued listing on the NASDAQ Global Select Market, barring any further suspensions of these rules.

If our common stock loses its status on the NASDAQ Global Select Market, shares of our common stock would likely trade on the over-the-counter market bulletin board, commonly referred to as the pink sheets. If our stock were to trade on the over-the-counter market, selling our common stock could be more difficult because smaller quantities of shares would likely be bought and sold, transactions could be delayed, and security analysts' coverage of us may be reduced. In addition, in the event our common stock is delisted, broker-dealers have certain regulatory burdens imposed upon them, which may discourage broker-dealers from effecting transactions in our common stock, further limiting the liquidity thereof. These factors could result in lower prices and larger spreads in the bid and ask prices for shares of common stock.

Some anti-takeover provisions of our charter documents, agreements and plans may delay or prevent a takeover of the Company. A number of provisions of our articles of incorporation and bylaws impact matters of corporate governance and the rights of shareholders. Certain of these provisions have an anti-takeover effect and may delay or prevent takeover attempts not first approved by the Board of Directors (including takeovers that certain shareholders may deem to be in their best interests). These provisions also could delay or frustrate the removal of incumbent directors or the assumption of control by shareholders. We believe that these provisions are appropriate to protect our interests and all of our shareholders.

Under the terms of the Exclusive Supply Agreement, we are prohibited from entering into an exclusive marketing or distribution agreement with DeBeers or its affiliates or any party whose primary business is the development, manufacture, marketing or sale of diamond gemstones or any non-gemstone and non-jewelry industry competitor of Cree. The Agreement also prohibits us from entering into certain merger, acquisition, sale of assets or similar transactions with a prohibited party. These provisions of the Exclusive Supply Agreement with Cree could limit the price that third parties might be willing to pay in the future for some or all of the shares of our common stock. In addition, this agreement could prevent us from entering into certain potentially profitable transactions with such prohibited parties.

On February 21, 1999, we adopted a Shareholder Rights Plan under which all shareholders of record as of March 8, 1999, received rights to purchase shares of a new series of Preferred Stock (the Rights Plan). Each share of common stock issued after March 8, 1999 has received the same rights. The Rights Plan, as modified by an amendment dated February 18, 2009, remains in full force and effect.

The Rights Plan is designed to enable all of our shareholders to realize the full value of their investment and to provide for fair and equal treatment for all shareholders in the event that an unsolicited attempt is made to acquire us. The adoption of the Rights Plan is intended as a means to guard against abusive takeover tactics and is not in response to any particular proposal. The Rights, which expire in 2019, will be exercisable only if a person or group acquires 20% or more of our common stock or announces a tender offer for 20% or more of the common stock. If a person or group acquires 20% or more of our common stock, all shareholders except the purchaser will be entitled to acquire our common stock at a 50% discount. The effect will be to discourage acquisitions of more than 20% of our common stock without negotiations with the Board of Directors of the Company.

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The Rights will trade with our common stock, unless and until they are separated upon the occurrence of certain future events. Our Board of Directors may redeem the Rights prior to the expiration of a specified period following the acquisition of more than 20% of our common stock.

We have had significant changes in our management and these changes may impact our ability to execute our business strategy in the near term. On July 21, 2008, Robert S. Thomas resigned as the Company's Chief Executive Officer, Chairman of the Board of Directors and as a director. At the time of Mr. Thomas' resignation, Dr. Frederick A. Russ, the lead independent director, became the interim Chairman of the Board of Directors and Dennis M. Reed, the Company's then President and Chief Marketing Officer, assumed responsibility for managing the Company's total operations and was designated as the principal executive officer of the Company. Effective September 30, 2008, James R. Braun resigned as the Company's Chief Financial Officer and Vice President of Finance. On October 1, 2008, Neil Boss, the Controller of the Company since 2002, was appointed as the principal accounting officer and principal financial officer of the Company.

On February 3, 2009, the Company elected George R. Cattermole, a current director, as Chairman of the Board of Directors and entered into the Management Services Agreement with Bird Capital Group, Inc. ("BCG") under which BCG will provide management services to the Company, including the services of Richard A. Bird as the Company's full-time non-employee Chief Executive Officer. On February 5, 2009, the Company ended its employment relationship with three executive officers: Dennis M. Reed, who had served as President and Chief Marketing Officer since March 2007 and principal executive officer since July 2008; Carl A. Mielke, Senior Vice President of Sales; and Steven L. Abate, Vice President of Operations.

Our success will depend to a significant extent on the ability of BCG and Mr. Bird to develop and implement a successful strategy, to successfully lead and motivate our employees, and to work effectively with other members of our management team and our board of directors, which also underwent a significant change in composition in 2008. There can be no assurance that changes in management will lead to an improvement in our results of operations. If the leadership transition is not successful, we may experience disruption to our operations, which may have a material adverse affect on our business and financial condition.

Adverse resolution of legal proceedings may harm our operating results and financial condition. We are a party to certain legal proceedings as discussed in greater detail under Item 3, "Legal Proceedings" of this Annual Report on Form 10-K. Litigation and other legal proceedings can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular legal proceeding could have a material adverse effect on our business, operating results, and financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease approximately 16,500 square feet of mixed-use space (general office, light manufacturing and laboratory) in the Research Triangle Park area of North Carolina from an unaffiliated third party. This lease expires in July 2011. This space houses the majority of all United States personnel, including our executive offices, sales offices, administrative personnel and production facilities. This space is being fully utilized and management considers this space to be sufficient for our foreseeable needs over the next 12 months.

We also have a lease for general office space in Hong Kong that was used by our subsidiary in Hong Kong that ceased operations in August 2008. The lease expires in December 2009 and the space is not currently being utilized.

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ITEM 3. LEGAL PROCEEDINGS

On October 4, 2006, we received an English translation of an action filed on June 9, 2006 in the South Korean Intellectual Property Office by MC Lab Corporation. MC Lab Corporation sought invalidation of our South Korean gemstone patent on the basis of an alleged lack of inventiveness as compared to certain prior art. In September 2007, the petition by MC Lab Corporation to invalidate our patent was dismissed. On September 29, 2007, MC Lab Corporation filed a Notice of Appeal with the Patent Court. On April 15, 2008, the first court hearing of the appeal was held and several other hearings have been held since that time. A final hearing was held on October 30, 2008, and on December 11, 2008, the South Korean Patent Court ruled our patent to be invalid. On December 29, 2008, MC Lab Corporation contacted us regarding an offer of settlement. On January 2, 2009, we filed a Notice of Appeal to the South Korean Supreme Court. The appeal is currently stayed pending efforts to settle the matter outside of the court system. Management believes that the South Korean patent was properly issued and we will vigorously appeal the decision of the South Korean Patent Court if a settlement can not be reached. We do not presently have material sales in South Korea and the decision will not be legally binding in any other jurisdiction.

On June 16, 2008, we filed a collection action in the United States District Court, Eastern District of North Carolina, Western Division, against K&G Creations for collection of in excess of \$2.8 million owed to us under a Manufacturing Agreement between the Company and K&G Creations that was terminated as of December 31, 2007. We seek to recover approximately \$2.8 million, with interest accruing at the contract rate of 12% from July 4, 2008, for moissanite jewels delivered and sold to K&G Creations. On July 14, 2008, K&G Creations filed its answer, counterclaim and related pleadings in which it generally denied our claims and asserted counterclaims against us and certain of our now former executive officers for \$50 million for alleged breach of the Manufacturing Agreement in connection with alleged overcharges for moissanite jewels, misrepresentations regarding pricing, interference with its business relationships, forcing K&G Creations out of the moissanite business and related matters. On February 23, 2009, we announced that our discussions with K&G Creations regarding possible settlement of litigation between the parties have been unsuccessful. Management believes that the counterclaims are without merit and we intend to vigorously pursue our claims against K&G Creations and vigorously defend against the counterclaims. The case is currently scheduled for trial in December 2009.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****(a) Market for Registrant's Common Equity**

Our common stock is traded on the NASDAQ Global Select Market under the symbol CTHR. The following table presents, for the periods indicated, the high and low sales prices of our common stock, as reported by the NASDAQ Global Select Market. As of February 27, 2009 there were 212 shareholders of record of our common stock.

	2008		2007	
	High	Low	High	Low
First Quarter	\$ 2.26	\$ 1.12	\$ 8.10	\$ 5.96
Second Quarter	1.40	1.06	6.95	4.00
Third Quarter	1.17	0.48	5.73	3.75
Fourth Quarter	0.62	0.18	4.35	2.12

We did not pay any dividends on our common stock during the fiscal year 2008. On April 24, 2007, the Company declared an \$0.08 per share cash dividend distributed on June 15, 2007. Pursuant to this dividend, total cash of \$1,448,424 was distributed to shareholders.

We will regularly review and consider the best policies and practices for the Company, including the dividend policy. The payment of future dividends will be dependent on the facts and circumstances at the time of that review.

(c) Issuer Purchases of Equity Securities

None.

ITEM 6. SELECTED FINANCIAL DATA

The information required by this Item 6 is not required to be provided by issuers that satisfy the definition of smaller reporting company under SEC rules.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

All statements, trend analysis and other information contained in the following discussion relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements, including words such as anticipate, believe, plan, estimate, expect and intend and other similar expressions constitute forward-looking statements. Our business is subject to business and economic risks and uncertainties, and our actual results of operations may differ materially from those expressed or implied in the forward-looking statements. The following discussion and the discussion in Item 1A Risk Factors of this Annual Report on Form 10-K describes some, but not all, of the factors that could cause these differences.

Overview

We manufacture, market and distribute Charles & Colvard created Moissanite jewels (also called moissanite) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral found primarily in meteors. As the sole manufacturer of scientifically-made moissanite jewels, our strategy is to establish Charles & Colvard as a

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reputable, high-quality and sophisticated brand and position moissanite as a unique jewel, distinct from all others based on its exceptional fire, brilliance, luster, durability and rarity. Moissanite has primarily been marketed to the self-purchasing woman as the perfect reward or indulgence for a woman celebrating her achievements or milestones in her life. Beginning in 2008 and continuing in to 2009, Charles & Colvard has expanded its marketing message beyond the self-purchasing woman to include a larger marketplace such as, bridal, anniversary and gift-giving. Moissanite is also marketed to the jewelry trade as a new jewelry category with a unique business opportunity.

Sales for 2008 were 47% less than sales during 2007 primarily due to the actions by U.S. retailers to reduce their current inventory levels due to the challenging U.S. economic environment. There has been a pullback in consumer spending that has affected the jewelry industry more severely than most consumer products. Also negatively impacting revenue during 2008 was the termination of our manufacturing agreements with K&G Creations (K&G) and Reeves Park, Inc. (Reeves Park). We terminated our relationship with K&G effective January 1, 2008 and worked during 2008 to transition several retailers to new moissanite jewelry manufacturing customers of the Company to replace the jewelry previously supplied by K&G. This transition was substantially completed in the second half of 2008 and we began to see new order flow late in 2008 from those retailers that continued in the moissanite jewelry business. Our manufacturing agreement with Reeves Park was terminated during the fourth quarter of 2008 due to repeated failure by Reeves Park to make timely payments on their open receivables. We are currently in the process of reviewing the retail accounts supplied by Reeves Park in an attempt to ensure these retailers can still purchase moissanite jewelry.

Net loss for 2008 was \$6.2 million, or \$0.34 per diluted share, compared with a net loss of \$24,424, or \$0.00 per diluted share, for 2007. Included in the net loss for 2008 were (all items are net of income tax) \$1.7 million as a bad debt allowance against two specific customers, \$0.5 million related to severance costs, \$0.2 million related to closure of our operations in Hong Kong and China, and \$0.2 million related to the increased reserves on jewelry inventory and consigned inventory. The total of these losses was \$2.6 million, net of income tax. Also included in the 2008 net loss was \$1.6 of million of additional income tax expense due to the establishment of a valuation allowance against certain United States deferred tax assets. The allowance was established due to the Company s 2008 net loss and uncertainty over whether the Company will be able to generate sufficient future taxable income to fully use the Company s net operating loss carry-forward and other deferred tax assets.

At our annual meeting of shareholders on May 27, 2008, the composition of our board of directors changed significantly with the election of three new members Richard A. Bird, George R. Cattermole and Ollin B. Sykes. On July 21, 2008, Robert S. Thomas resigned as the Company s Chief Executive Officer, Chairman of the Board of Directors and as a director. At the time of Mr. Thomas resignation, Dr. Frederick A. Russ, the lead independent director, became the interim Chairman of the Board of Directors and Dennis M. Reed, the Company s then President and Chief Marketing Officer, assumed primary responsibility for managing the Company s total operations and was designated as the principal executive officer of the Company. Effective September 30, 2008, James R. Braun resigned as the Company s Chief Financial Officer and Vice President of Finance. On October 1, 2008, Neil Boss, the Controller of the Company since 2002, was appointed as the principal accounting officer and principal financial officer of the Company. On February 3, 2009, the Company elected George R. Cattermole as Chairman of the Board of Directors and entered into the Management Services Agreement with Bird Capital Group, Inc. (BCG) under which BCG will provide management services to the Company, including the services of Richard A. Bird as the Company s full-time non-employee Chief Executive Officer. The Management Services Agreement is discussed in greater detail under the Liquidity and Capital Resources section of this Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

On February 5, 2009, the Company ended its employment relationship with three executive officers: Dennis M. Reed, who had served as President and Chief Marketing Officer since March 2007 and principal executive officer since July 2008; Carl A. Mielke, Senior Vice President of Sales and Steven L. Abate, Vice President of Operations.

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Other initiatives undertaken to improve our financial condition were to negotiate with our two leading raw material suppliers to defer purchases during the three months ended December 31, 2008 into 2009, while keeping in place our long term supply agreements, close our operations in Hong Kong and China, and to reduce the size of our workforce. In addition to the personnel changes discussed above, the organizational structure of the Company has been streamlined through the elimination of other positions within the organization. During 2008, the Company expensed approximately \$659,000 in severance pay. Additionally, the management team and certain other employees agreed to a 10% rollback in salary for the three months ended December 31, 2008. The organizational changes will result in salary savings of approximately \$1.0 million in 2009, net of the \$1,025,000 in base payments to be made to BCG and other severance and consulting fees.

Due to the difficult economic environment, our first priorities are to generate positive cash flow and to stabilize the Company's financial position through cost cutting initiatives and selling down our inventory by increasing sales with new and current customers. As discussed above, we have already taken some significant steps to reduce costs. We believe that we can improve the Company's financial performance by executing a more selective and cost-effective marketing strategy.

Results of Operations

The following table shows certain Consolidated Statement of Operations data as a percentage of sales for the periods presented. A detailed explanation of our results of operations follows this table:

		Year Ended December 31,			
		2008		2007	
Net Sales	100%	\$ 14,727,054	100%	\$ 27,818,446	
Gross profit	62%	9,134,175	73%	20,209,951	
Marketing & sales expenses	51%	7,466,266	51%	14,086,863	
General & administrative expenses	57%	8,454,567	21%	5,720,996	
Operating income		(6,900,279)	1%	325,446	
Net income (loss)		(6,151,128)		(24,424)	

Year ended December 31, 2008 compared with Year ended December 31, 2007.

Net sales were \$14,727,054 for the year ended December 31, 2008 compared to \$27,818,446 for the year ended December 31, 2007, a decrease of \$13,091,392 or 47%. Shipments of moissanite jewels, excluding consigned jewels, decreased 52% to approximately 81,000 carats from 167,000 carats, while the average selling price per carat increased by 8%. U.S. sales accounted for approximately 70% and 82% of sales during the year ended December 31, 2008 and 2007, respectively.

U.S. net sales and carat shipments, excluding consigned jewels, decreased by 55% and 61%, respectively, for the year ended December 31, 2008 as compared to the year ended December 31, 2007. U.S. sales decreased primarily due to the actions by U.S. retailers to reduce their current inventory levels due to the challenging U.S. economic environment. There has been a pullback in consumer spending that has negatively affected the jewelry industry. Also negatively impacting revenue during 2008 was the termination of our manufacturing agreements with K&G Creations (K&G) and Reeves Park, Inc. (Reeves Park). We terminated our relationship with K&G Creations effective January 1, 2008 and worked during 2008 to transition several retailers to new moissanite jewelry manufacturing customers of the Company to replace the jewelry previously supplied by K&G. That transition was substantially completed in the second half of 2008 and we began to see new order flow late in 2008 from those retailers that continued in the moissanite jewelry business. During 2008, we did not have any sales to K&G and they accounted for 11% of our sales during 2007. Our manufacturing agreement with Reeves Park was terminated during the fourth quarter of 2008 due to repeated failure by Reeves Park to make timely payments on their open receivables. We are currently in the process of reviewing the retail accounts supplied by Reeves Park in an attempt to ensure these retailers can still purchase moissanite jewelry. As these former retailers of Reeves Park transition to new manufacturers, we will likely see a short term negative impact on our results of operations. Reeves Park accounted for 9% of our 2008 sales

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compared to 20% of our 2007 sales. Another factor impacting sales in 2008 was the lack of significant sales related to sell-in for retail stores that did not previously offer moissanite jewelry compared to approximately \$1.9 million of sales for sell-in during 2007. Our four largest customers during the year ended December 31, 2008 accounted for 21%, 9%, 9% and 8%, respectively, of our sales compared to 14%, 20%, 8% and 19%, respectively, for 2007. We expect that we will remain dependent on our ability and that of our largest customers to maintain and enhance their retail programs. A change in or loss of any of these customer or retailer relationships could have a material adverse effect on our results of operations.

International net sales and carat shipments decreased by 11% and 5%, respectively, for the year ended December 31, 2008 as compared to 2007. International sales decreased primarily due to decreased sales to Thailand, the United Kingdom, and Taiwan, partially offset by higher sales to Hong Kong/China and India. A portion of our international sales is due to jewels sold internationally that will be re-imported to North American retailers. Our top three international distributors during the year ended December 31, 2008 were located in Italy, Hong Kong/China and India. In August 2008, the Company closed its Hong Kong and China operations. The Company will continue to pursue its opportunities in Asia from the Company's United States office and all customers that had been serviced from the Hong Kong office have been transitioned to the Company's United States office.

Our gross profit margin was 62.0% for the year ended December 31, 2008 compared to 72.6% for the year ended December 31, 2007. The decreased gross profit margin percentage was primarily caused by higher production costs in the first-in, first-out accounting period relieved from inventory, the write-off of a portion of the consigned jewels returned to us by K&G in a damaged condition and an increase in the reserve on jewelry inventory, partially offset by an 8% increase in our average selling price per carat. The K&G write-off resulted in approximately a 2% point reduction in our gross profit percentage during the year ended December 31, 2008. We increased our reserve on jewelry inventory by \$220,000 during the year ended December 31, 2008. This reserve marks down our jewelry inventory to the value we believe we would obtain by melting the gold in the jewelry and putting the jewels that meet our grading criteria back into loose jewel inventory.

Marketing and sales expenses were \$7,466,266 for the year ended December 31, 2008 compared to \$14,086,863 for the year ended December 31, 2007, a decrease of \$6,620,597, or 47%. As a percentage of sales, these expenses were 51% in both periods. The primary reasons for the decrease in expenses were a \$5,416,000 decrease in advertising expenses and \$571,000 of decreased travel costs, partially offset by \$367,000 of severance costs. Our direct advertising costs decreased by \$4,425,000 primarily as a result of decreased print advertising while our co-op advertising expense decreased by \$991,000 due to lower sales. Our co-op advertising program reimburses a portion of our customers marketing costs based on the amount of their purchases from us, and is subject to the customer providing us documentation of all advertising that includes our products.

General and administrative expenses were \$8,454,567 for the year ended December 31, 2008 compared to \$5,720,996 for the year ended December 31, 2007 an increase of \$2,733,571, or 48%. As a percentage of sales, these expenses increased to 57% from 21% in the same period of 2007. The increase in expenses is primarily due to a \$1,492,000 increase in bad debt expense, \$903,000 of increased legal fees, and \$293,000 of severance costs. Bad debt expense during 2008 totaled \$2,683,000 reflecting an increase in the allowance for uncollectible accounts of \$2.1 million for Reeves Park and \$0.5 million for K&G. The increase in the allowance for uncollectible accounts reduced the net value of receivables remaining from Reeves Park to approximately \$2.3 million. This was based on the estimated net realizable value of the transactions resulting from the settlement agreement reached with Reeves Park in January 2009. The increase in the allowance attributable to K&G will fully reserve the outstanding balance due from K&G due to the uncertain nature of litigation. We filed a lawsuit against K&G in June 2008 to collect approximately \$2.8 million with interest accruing at the contract rate of 12% from July 4, 2008 for jewels sold to K&G. Bad debt expense during 2007 totaled \$1,191,000 primarily due to an increase in the allowance for uncollectible accounts of \$0.7 million for K&G and \$0.4 million for Reeves Park. Higher legal fees during 2008 compared to 2007 were the result of litigation costs for the South

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Korean patent and K&G lawsuits, as well as for the significant corporate changes undertaken by the Company during 2008. Based on successful court decisions on the South Korean patent suit in 2007 and early in 2008, we had capitalized \$349,000 of legal fees as an intangible asset. However, based on the negative decision received in December 2008 in this matter, we then expensed in 2008 the remaining unamortized value of \$322,000.

Interest income was \$116,484 for the year ended December 31, 2008 compared to \$491,138 for the year ended December 31, 2007, a decrease of \$374,654 or 76%. This decrease resulted from a lower interest rate earned on our cash balances and lower cash balances.

Our effective income tax rate for the year ended December 31, 2008 was 9% compared to 103% for the year ended December 31, 2007. Our statutory tax rate is 38.5% and consists of the Federal income tax rate of 34% and the North Carolina state income tax rate of 4.5%, net of the federal benefit. During 2008, we established a valuation allowance of \$1.6 million against certain United States deferred tax assets due to the Company's 2008 net loss and uncertainty over sufficient future taxable income to fully use the Company's net operating loss carry-forward and other deferred tax assets. Without the charges associated with the establishment of this valuation allowance, our effective income tax rate for 2008 would have been 32%. In 2007, when we had taxable income, our effective income tax rate was higher than our statutory rate primarily due to our inability to recognize an income tax benefit for our operating losses in Hong Kong and China. We did not recognize the income tax benefit of our losses in Hong Kong and China due to the uncertainty of generating sufficient future taxable income in those tax jurisdictions to offset the existing losses. As a result of our loss position in the U.S. during 2008, the effect of losses at our non-U.S. operations caused our effective tax rate to be lower when compared to the effective tax rate in 2007 when we had taxable income. Another factor impacting our effective tax rate is the Company's adoption of FIN 48 on January 1, 2007. Under the provisions of FIN 48, we recorded \$107,000 of additional income tax expense during 2007, increasing our 2007 effective tax rate by 13%. During 2008, we recorded \$52,000 of income tax expense under the provisions of FIN 48, excluding the FIN 48 impact of a 2008 tax deduction due to the closing of operations in Hong Kong and China. As a result of this 2008 tax deduction, we will receive an income tax benefit of \$2,172,000; however this benefit is not reflected in our 2008 income tax expense as the deduction is being treated as an uncertain tax position under the provisions of FIN 48.

Liquidity and Capital Resources

At December 31, 2008, we had approximately \$5.6 million of cash and equivalents and \$18.8 million of working capital as compared to \$7.0 million of cash and equivalents and \$30.5 million of working capital at December 31, 2007. As further described below, cash and equivalents decreased during the year ended December 31, 2008 primarily as a result of \$0.9 million of cash used in operations. The decrease in working capital is primarily attributable to the classification of inventory between current and long-term assets, the decreases in accounts receivable and cash, partially offset by increased income taxes receivable and decreased accounts payable. The Company increased the long-term portion of inventory due to decreasing sales and the uncertain economic environment over the next twelve months.

Our principal sources of liquidity are cash on hand and cash expected to be generated by operations in future periods. During the year ended December 31, 2008, \$0.9 million of cash was used in operations primarily as a result of our operating loss and a \$1.7 million decrease in accounts payable, partially offset by a \$2.8 million decrease in accounts receivable (excluding the impact of the change in reserves). Our decrease in accounts payable is primarily due to the reduction in expenses and inventory purchase commitments consistent with our efforts to reduce costs and inventory while conserving cash.

We significantly reduced our raw material inventory purchase commitments in 2008 over prior years to improve cash flow from operations. Further, we were able to negotiate with our two leading raw material suppliers to defer purchases during the three months ended December 31, 2008 into 2009, while keeping in place our long term supply agreements. We expect our reduced and deferred purchase commitments to help us convert inventory into cash at a faster rate. We purchased \$2.2 million of raw material during

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2008 compared to \$11.5 million of raw material in 2007. Our raw material inventories of SiC crystals are purchased under exclusive supply agreements with a limited number of suppliers. Because the supply agreements restrict the sale of these crystals to only us, the suppliers negotiate minimum purchase commitments with us that have resulted in levels of inventories that are higher than we might otherwise maintain. These agreements, coupled with lower than expected sales, resulted in \$34.7 million of our inventories being classified as long-term assets at December 31, 2008.

On June 6, 1997, we entered into an Amended and Restated Exclusive Supply Agreement with Cree. The Exclusive Supply Agreement had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the Exclusive Supply Agreement, we have committed to purchase a minimum of 50% (by dollar volume) of our requirements for SiC crystals from Cree. If our orders require Cree to expand beyond specified production levels, we must commit to purchase certain minimum quantities. We purchased \$1,672,000 of SiC crystals from Cree during the year ended December 31, 2008. In September 2008, the Company amended and supplemented its letter agreement with Cree to suspend the Company's commitment to purchase \$710,000 of silicon carbide inventory from Cree during the fourth quarter of 2008. This purchase commitment will be included in the Company's yet to be established 2009 purchase commitment with Cree.

In February 2005, we entered into an exclusive supply agreement with Norstel AB (Norstel) for the supply of SiC crystals for use in the manufacturing of moissanite jewels. In April 2008, we entered into an amendment to the exclusive supply agreement with Norstel due to an update of Norstel's delivery schedule and also due to our desire to limit our purchase of raw materials. Under the amendment, the Company's minimum purchase commitment from Norstel continues until (i) the Company has purchased an aggregate amount of approximately \$7.9 million of SiC crystals, or (ii) September 26, 2011, whichever occurs first. We purchased \$453,000 of SiC crystals from Norstel during the year ended December 31, 2008 and \$550,000 since inception of the exclusive supply agreement. In October 2008, the Company entered into a new letter agreement with Norstel which amended and supplemented the April 2008 amendment. Pursuant to the new letter agreement, the Company's commitment to purchase approximately \$750,000 of silicon carbide inventory from Norstel during the fourth quarter of 2008 was suspended and the Company will resume purchasing from Norstel in 2009. It is not yet determined what the Company's total commitment from Norstel will be for 2009, although we have committed to purchase a minimum of 40% of our quarterly SiC requirements from Norstel. In addition, we advanced \$400,000 to Norstel in 2005 for the purchase of certain equipment. This advance, which is in the form of a note receivable, began to be repaid in January 2007 through a 20% reduction on the invoice for subsequent purchases of SiC crystals. Effective March 1, 2008, pursuant to the April 2008 amendment, we began receiving a 30% reduction on the invoice for subsequent purchases of SiC crystals from Norstel, and will continue to receive this reduction until the advance is repaid. The balance on the advance as of December 31, 2008 was \$224,627. Due to the suspension of purchases with Norstel, the Company classified \$82,627 of this note receivable as long-term on the Company's condensed consolidated balance sheets as of December 31, 2008.

In December 2008, we entered into a research and development agreement that requires us to pay \$50,000 per month for six months beginning in January 2009.

As of December 31, 2008, we had trade accounts receivable from Reeves Park of \$4.9 million, or 62% of receivables (not considering our allowances for uncollectible accounts or returns). As of December 31, 2007, trade accounts receivable from Reeves Park was \$6.0 million, or 56% of our receivables (not considering our allowances for uncollectible accounts or returns). In March 2008, we signed a manufacturing agreement with Reeves Park that allowed Reeves Park to continue receiving orders from us as long as it paid a specified amount higher than the amount of its new orders. There was also a minimum payment amount to be made quarterly and monthly interest payments that Reeves Park was required to pay. In September 2008, Reeves Park stopped making payments required under the March 2008 agreement. In October 2008, we amended the March 2008 manufacturing agreement with Reeves Park and agreed to continue shipping orders on a 100% prepaid basis if Reeves Park paid for all billings on items sold from consignment as they came due. We entered into the amendment to ensure a flow of

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jewelry to retailers during the holiday season while we continued to pursue collection of the outstanding balance due from Reeves Park. The amendment also provided Reeves Park with the required notice of good cause to terminate the manufacturing agreement due to Reeves Park's failure to make contractual payments on their outstanding balance. In November 2008, both the manufacturing agreement and the amendment with Reeves Park were terminated due to Reeves Park's repeated failure to make timely payments for moissanite shipped to Reeves Park. In January 2009, we entered into a settlement agreement with Reeves Park to settle the outstanding balance by accepting a return of inventory, the receipt of certain cash payments due to Reeves Park from its customers, and the payment of a settlement fee to the Company by Reeves Park. Based on the \$2.3 million estimated net realizable value of the transactions under the settlement agreement, the Company increased its allowance for uncollectible accounts during 2008 for Reeves Park to \$2.6 million. The majority of the jewelry received is valued at scrap value due to the lack of a plan to market this inventory. The inventory received from this transaction will be received in early 2009 and is not reflected on our balance sheet as of December 31, 2008.

On February 3, 2009, we entered into the Management Services Agreement (the Agreement) with Bird Capital Group, Inc. (BCG) under which BCG will provide management services to the Company, including the services of Richard A. Bird, a current director of the Company, as the Company's full-time non-employee Chief Executive Officer. The services to be provided by BCG include the development of a new strategy of the Company for growth and competitive success. The initial term of the Agreement is scheduled to end on December 31, 2010. After the initial term, the Agreement would automatically renew for three successive one-year terms unless terminated by the Company within 30 days of the receipt of audited year-end financial statements if the Company has not met certain annual sales and operating income thresholds. The Agreement is terminable for cause (as defined in the Agreement) or upon the death or incapacitation of Mr. Bird. BCG also may terminate the Agreement if there is a Change of Control (as defined in the Agreement) of the Company at any time prior to February 1, 2014. Upon such termination, BCG would receive all money and bonuses due under the Agreement plus an early termination payment equal to \$1,400,000 if the Change of Control occurs before February 1, 2011 and \$900,000 if the Change of Control occurs on or after February 1, 2011, provided that the early termination payment for a Change of Control on or after February 1, 2011 would be payable only if the annual sales or operating income threshold referred to above is met for the calendar year immediately preceding the Change of Control.

The Agreement provides for monthly management fees payable to BCG. BCG will receive \$75,000 per month during 2009, except the monthly fee will be \$175,000 per month during the first two months of the Agreement to compensate BCG for the additional work with respect to the new strategy. Beginning on January 1, 2010 and on January 1 of each succeeding year of the Agreement, the fee will be subject to certain adjustments. The Agreement also provides for potential short and long-term bonuses payable to BCG. BCG would receive a one-time bonus equal to 10% of any realized gross profit, with certain exceptions, that is collected in cash from the reduction of finished goods inventory as of January 31, 2010 compared to January 31, 2009. In addition, BCG would receive a possible bonus based on any net amounts realized upon any settlement of certain pending litigation. Long-term bonuses potentially payable to BCG include an annual bonus equal to 20% of the Company's operating income before or excluding (i) interest, income taxes, depreciation and amortization, (ii) charges or accruals for long-term bonuses payable to BCG and, (iii) certain extraordinary and nonrecurring items. Upon the earlier of any Sale Transaction (as defined in the Agreement) of the Company or termination of the Agreement, BCG also will receive a one-time bonus equal to 20% of the amount by which the Company's total market valuation exceeds the Company's market valuation on the date of the Agreement. The Company's market valuation is determined based on the Sale Transaction or the market price of the Company's common stock, as applicable.

We did not make any income tax payments during the year ended December 31, 2008 due to our loss position. As of December 31, 2008 we have an income tax receivable in the amount of \$2,074,420 and we expect to receive these funds in the middle of 2009. Included on our 2008 tax return is a significant tax deduction related to the closing of operations at our Hong Kong subsidiary. We have treated this deduction as an uncertain tax position under the provisions of FIN 48, resulting in no income tax benefit on our 2008 statement of operations for this deduction.

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Our future capital requirements and the adequacy of available funds will depend on many factors, including the risk factors described in greater detail under Item 1A Risk Factors of this Annual Report on Form 10-K. Based on our cash and equivalents and other working capital, management believes that our existing capital resources are adequate to satisfy our capital requirements for at least the next 12 months provided that there are no extraordinary events and that economic conditions impacting consumer spending do not further deteriorate and adversely affect the demand for moissanite.

As discussed above, during 2008 we have taken certain actions to reduce costs and to increase our cash flow from operations. Specifically, these actions include: 1) the closing of our operations in Hong Kong and China 2) negotiating lower purchase commitments for raw materials inventory and 3) reducing staffing levels. The Company also entered into the Management Services Agreement (the Agreement) with Bird Capital Group, Inc. (BCG) under which BCG will provide management services to the Company, including the services of Richard A. Bird as the Company's full-time non-employee Chief Executive Officer. The services to be provided by BCG include the development of a new strategy of the Company for growth and competitive success. One of the primary objectives of this plan will be to establish methods to allow the Company to reduce inventory levels through increased sales. Management believes that the Company will be able to satisfy its 2009 sales requirements without any additional purchases of raw material inventory. We will continue our efforts to increase financial flexibility during this difficult economic environment. There can be no assurance that the efforts taken to date and future actions will be able to withstand the impact of any economic downturn that extends deeper or longer than we currently anticipate. Under these conditions, our operations and other sources of funds may not be sufficient to fund our operations, and we may be required to seek alternative sources of funding. There is no assurance, however, that we will be able to obtain financing on acceptable terms, or at all, especially in light of the ongoing turmoil in the financial markets described in greater detail under Item 1A, Risk Factors of this Annual Report on Form 10-K.

Net Operating Loss Carryforward

Due to the carry back of our 2008 taxable loss against taxes paid in prior years, we have \$1.0 million of remaining federal income tax credits that can be carried forward to offset future income. These credits begin expiring in 2012.

At December 31, 2008, the Company has a North Carolina tax NOL carryforward of approximately \$7.8 million that begins to expire in 2013. This NOL can be used to offset future state taxable income.

During 2008, we established a valuation allowance of \$1.6 million against certain United States deferred tax assets due to the Company's 2008 net loss and uncertainty over sufficient future taxable income to fully use the Company's net operating loss carry-forward and other deferred tax assets.

As of December 31, 2008, there was approximately \$6.0 million in NOL carryforwards in Hong Kong. In accordance with the Hong Kong tax code these amounts can be carried forward indefinitely to offset future taxable income in Hong Kong. Due to the closing of operations at our Hong Kong office, we do not expect to utilize any of the Hong Kong NOL carryforward available to us.

As of December 31, 2008, there was approximately \$701,000 in NOL carryforwards in China. In accordance with the China tax code these amounts can be carried forward five years to offset future taxable income in China. The NOL carryforwards began expiring in 2008. We will not utilize this carry forward due to the closing of operations in China during 2008.

Table of Contents*Critical Accounting Policies and Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates impacting our consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions and co-op advertising. We also have other policies that we consider key accounting policies, the most significant of which is our policy for revenue recognition; however, this policy typically does not require us to make estimates or judgments that are difficult or subjective.

Inventories are stated at the lower of cost or market determined on a first in, first out basis. Our finished goods inventory consists primarily of near-colorless moissanite jewels that meet rigorous grading criteria and are of cuts and sizes most commonly used in the jewelry industry. Any inventory in excess of the Company's current requirements based on anticipated levels of sales is classified as long-term on the Company's consolidated balance sheets. Our classification of long-term inventory requires us to estimate the portion of inventory that can be realized over the next 12 months. As of December 31, 2008, we carry only a limited amount of moissanite jewels in finished jewelry settings. Our inventories do not degrade in quality over time and are not subject to fashion trends. Moissanite jewel properties do not change over time. We have very small market penetration in the worldwide jewelry market and the Company has the exclusive right through 2015 to produce and sell lab-created silicon carbide (SiC) for use in jewelry applications. In view of the foregoing factors, we have concluded that no excess or obsolete inventory reserve requirements exist as of December 31, 2008. During 2002, we established a lower of cost or market reserve of \$400,000 to allow for a portion of the finished goods inventory to be re-cut. There are certain jewels in inventory that can be re-cut to achieve higher quality standards. To determine this reserve, we estimated the amount of inventory that is anticipated to be re-cut and the amount of weight loss that will occur during the process. Since the establishment of this reserve, we have not yet re-cut any jewels. At December 31, 2008, the reserve remained at \$400,000.

Estimates are used to determine the amount of two reserves against accounts receivable. The first reserve is an Allowance for Returns . At the time revenue is recognized, we estimate future returns and reduce sales and accounts receivable by this estimated amount. This amount is estimated using the historical return rate for our Company and considers any contractual return privileges granted to customers. The allowance for returns was \$295,000 and \$165,000 at December 31, 2008 and 2007, respectively. Second, an Allowance for Doubtful Accounts is established to reduce accounts receivable to an amount expected to be collected. Based on our collection history, we determine a percentage based on the age of the receivable that we deem uncollectible. The allowance is then calculated by applying the appropriate percentage to each of our receivables. Any increases or decreases to this allowance are charged or credited to general and administrative expenses. Any accounts with significant balances are reviewed separately to determine an appropriate allowance based on the facts and circumstances of the specific account. During our review for 2008, we specifically reviewed and recorded an allowance for the balances owed to us by Reeves Park and K&G Creations. The total allowance for doubtful accounts was \$3,915,000 and \$1,240,000 at December 31, 2008 and 2007, respectively. The portion of the allowance for doubtful accounts at December 31, 2008 attributable to Reeves Park was \$2,615,000 and the portion attributable to K&G Creations was \$1,175,000. We had to make significant estimates on the net realizable value of the transactions resulting from our January 2009 settlement agreement with Reeves Park to determine the appropriate allowance, including the portion of the jewelry inventory that is saleable and the scrap value for the remaining portion of the inventory received. The reserve for K&G reduced the value of the receivable on the books to zero due to the uncertainty of litigation.

Accounting rules require that all deferred tax assets of the company be assessed to determine if a valuation allowance is required. A valuation allowance is required if it is determined that it is more likely than not (50%) that some portion or all of the deferred tax assets will not be realized. The

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accounting rules state further that forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Based on our large losses during 2008 and the lack of verifiable positive evidence of sufficient future taxable income to fully use the Company's net operating loss carry-forward and other deferred tax assets, we established a valuation allowance during 2008 of \$1.6 million against certain United States deferred tax assets. This assessment will continue to be addressed in all future periods. All of our deferred tax assets in Hong Kong and China are fully reserved with a valuation allowance and have been fully reserved in all prior periods due to uncertainty of future taxable income in these jurisdictions to utilize the deferred tax assets.

Effective January 1, 2007, we adopted the provisions of FIN 48. FIN 48 provides guidance on the de-recognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. During 2008, the Company closed the operations of its Hong Kong subsidiary. As a result, we will have a significant tax deduction on our 2008 tax return resulting from unpaid obligations of the subsidiary to the Company. We have determined that this deduction qualifies as an uncertain tax position under the provisions of FIN 48. While we did take this deduction on our 2008 tax return and reflect the effect of this deduction in our income tax receivable and deferred tax assets, we also recorded a long term accrued income tax liability of \$2.2 million due to the transaction. This liability will be resolved when we get an official ruling from the IRS on the deduction or when the statute of limitations expires. If the deduction is resolved in a favorable manner, we will reverse all or some of this liability and credit income tax expense for the same amount.

We offer a co-op advertising program to many of our customers that reimburses a portion of their marketing costs based on their net purchases from us. At the end of any given period, we estimate the amount of co-op advertising expense that has not yet been submitted for credit by our customers. These amounts were \$401,849 and \$452,792 at December 31, 2008 and 2007, respectively. We estimate this amount based on our historical experience with each customer, and the related contractual arrangements to provide certain levels of co-op advertising for our customers.

Revenue is recognized when products are shipped, excluding memo or consignment shipments as discussed below. Our standard payment terms are generally between 30 and 60 days for jewel distributors and generally between 60 to 120 days for jewelry manufacturers. Some customers are required to prepay prior to shipment. For all jewels shipped, title passes upon shipment of the jewels from our facility (i.e., FOB-shipping point). Periodically, the Company sells jewels to customers on memo terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Our customers are generally required to make payments on memo shipments within 60 days upon the customer informing the Company that they will keep the jewels. Accordingly, the Company does not recognize revenue on these memo transactions until the earlier of (1) the customer informing the Company that they will keep the jewels or (2) the expiration of the right of return period. All memo shipments are shown on our balance sheets as inventory on consignment.

Newly Adopted Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). This standard defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. FASB Staff Position 157-2 (FSP FAS 157-2) delayed the effective date of FAS 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We adopted FAS 157 on January 1, 2008, and utilized the one year deferral for nonfinancial assets and nonfinancial liabilities that was granted by FSP FAS 157-2. The adoption of FAS 157 did not have an effect on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (FAS No. 159). FAS 159 permits entities to measure eligible financial assets, financial

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liabilities and firm commitments at fair value, on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other generally accepted accounting principles. The fair value measurement election is irrevocable and subsequent changes in fair value must be recorded in earnings. FAS 159 was effective for us beginning January 1, 2008. The adoption of FAS 159 did not have an effect on our consolidated financial statements since we did not elect the fair value option.

Newly Issued Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (FAS 141R). FAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. FAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. This statement is effective for business combinations occurring on or after January 1, 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No. 51* (FAS 160). FAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. FAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for us beginning January 1, 2009. We do not expect the adoption of FAS 160 to have an effect on our consolidated financial statements.

Off-Balance Sheet Arrangements

We have not engaged in any off-balance sheet financing arrangements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this Item 7A is not required to be provided by issuers that satisfy the definition of smaller reporting company under SEC rules.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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All other schedules are omitted due to the absence of the conditions under which they are required or because the required information is included within the consolidated financial statements or the notes thereto included in Item 8.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Charles & Colvard, Ltd.

Morrisville, North Carolina

We have audited the accompanying consolidated balance sheets of Charles & Colvard, Ltd. and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2008. Our audits also included the financial statement schedule listed in the Index at Item 8. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Charles & Colvard, Ltd. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 11 to the consolidated financial statements, in 2007, the Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*.

/s/DELOITTE & TOUCHE LLP

Raleigh, North Carolina

March 31, 2009

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CHARLES & COLVARD, LTD. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2008, 2007, and 2006

	Year Ended December 31,		
	2008	2007	2006
Net sales	\$ 14,727,054	\$ 27,818,446	\$ 40,712,085
Cost of goods sold	5,592,879	7,608,495	10,795,224
Gross profit	9,134,175	20,209,951	29,916,861
Operating expenses:			
Marketing and sales	7,466,266	14,086,863	16,106,506
General and administrative	8,454,567	5,720,996	4,307,749
Research and development	113,621	76,646	73,226
Total operating expenses	16,034,454	19,884,505	20,487,481
Operating income (loss)	(6,900,279)	325,446	9,429,380
Interest income	116,484	491,138	741,161
Income (loss) before income taxes	(6,783,795)	816,584	10,170,541
Income tax expense (benefit) (Note 11)	(632,667)	841,008	4,065,206
Net income (loss)	\$ (6,151,128)	\$ (24,424)	\$ 6,105,335
Net income (loss) per share (Note 2)			
Basic	\$ (0.34)	\$ (0.00)	\$ 0.34
Diluted	\$ (0.34)	\$ (0.00)	\$ 0.33
Weighted-average common shares (Note 2)			
Basic	18,240,853	18,065,739	18,160,218
Diluted	18,240,853	18,065,739	18,662,770

Share and per share data for all periods presented reflect the effect of the one share for every four shares owned stock split, effected in the form of a 25% stock dividend, distributed on January 30, 2006.

See notes to consolidated financial statements.

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CHARLES & COLVARD, LTD. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31, 2008 and 2007

	December 31,	
	2008	2007
Assets		
Current Assets:		
Cash and equivalents	\$ 5,587,144	\$ 7,048,409
Accounts receivable, net of allowance for doubtful accounts		
of \$3,915,000 and \$1,240,000, respectively	3,754,657	9,381,719
Interest receivable	2,747	7,457
Income tax receivable	2,074,420	82,191
Note receivable	142,000	365,390
Inventory, net (Note 3)	6,849,239	14,426,000
Inventory on consignment, net (Note 4)	1,442,608	1,763,243
Prepaid expenses and other assets	500,643	759,627
Deferred income taxes (Note 11)	1,231,071	980,674
Total current assets	21,584,529	34,814,710
Long Term Assets:		
Note receivable	82,627	
Inventory, net (Note 3)	34,727,841	26,851,837
Furniture and equipment, net (Note 5)	412,234	597,349
Patent and license rights, net (Note 5)	279,315	358,330
Deferred income taxes (Note 11)	940,903	528,525
Total long term assets	36,442,920	28,336,041
Total assets	\$ 58,027,449	\$ 63,150,751
Liabilities and Shareholders Equity		
Current Liabilities:		
Accounts payable:		
Cree, Inc. (Note 12)	\$	\$ 469,899
Other	1,631,074	2,880,137
Deferred revenue	171,181	
Accrued payroll	144,189	256,344
Accrued co-op advertising	401,849	452,792
Accrued expenses and other liabilities (Note 6)	479,395	268,973
Total current liabilities	2,827,688	4,328,145
Long Term Liabilities		
Accrued income taxes (Note 11)	3,154,110	911,606
Total liabilities	5,981,798	5,239,751
Commitments and contingencies (Note 12)		
Shareholders Equity (Notes 7 and 8)		
Common stock, no par value; 50,000,000 shares authorized; 18,334,136 and 18,106,526 shares issued and outstanding at December 31, 2008 and 2007, respectively	52,910,075	52,910,075
Additional paid-in capital Share based compensation	6,177,246	5,892,730

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Accumulated other comprehensive gain - Foreign currency translation		881
Accumulated deficit	(7,041,670)	(892,686)
Total shareholders' equity	52,045,651	57,911,000
Total liabilities and shareholders' equity	\$ 58,027,449	\$ 63,150,751

See notes to consolidated financial statements.

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CHARLES & COLVARD, LTD. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND
COMPREHENSIVE INCOME (LOSS)
FOR THE YEARS ENDED DECEMBER 31, 2006, 2007, and 2008

	Common Stock		Additional Paid-in Capital	Accumulated other Comprehensive	Retained Earnings (Deficit)	Total Shareholders Equity	Total Comprehensive Income (Loss)
	Number Of Shares	Amount	-Share Based Compensation	Gain (Loss)			
Balance at January 1, 2006	18,299,354	\$ 57,785,576	\$ 5,313,044	\$ (2,851)	\$ (5,130,151)	\$ 57,965,618	
Share-based compensation			324,477			324,477	
Stock options exercised	66,192	248,812	(3,425)			245,387	
Issuance of restricted stock	27,377						
Shares repurchased	(415,000)	(4,059,719)				(4,059,719)	
Cash dividend - \$.08 per share		(1,456,080)				(1,456,080)	
Stock dividend cash in lieu of fractional shares		(24,280)				(24,280)	
Tax effect of share-based compensation			173,783			173,783	
Foreign currency translation				2,394		2,394	\$ 2,394
Net income					6,105,335	6,105,335	6,105,335
Total comprehensive income							6,107,729
Balance at December 31, 2006	17,977,923	52,494,309	5,807,879	(457)	975,184	59,276,915	
Share-based compensation			573,454			573,454	
Stock options exercised	64,797	422,347	(191,383)			230,964	
Issuance of restricted stock	63,806						
Cash dividend - \$.08 per share		(6,581)			(1,441,843)	(1,448,424)	
Tax effect of share-based compensation			(297,220)			(297,220)	
Foreign currency translation				1,338		1,338	1,338
Cumulative effect of adoption of FIN 48					(401,603)	(401,603)	
Net loss					(24,424)	(24,424)	(24,424)
Total comprehensive loss							(23,086)
Balance at December 31, 2007	18,106,526	52,910,075	5,892,730	881	(892,686)	57,911,000	
Share-based compensation			471,098			471,098	
Tax effect of share-based compensation			(186,582)			(186,582)	
Issuance of restricted stock	227,610						
Foreign currency translation				(881)	2,144	1,263	1,263
Net loss					(6,151,128)	(6,151,128)	(6,151,128)
Total comprehensive loss							\$ (6,149,865)
Balance at December 31, 2008	18,334,136	\$ 52,910,075	\$ 6,177,246	\$	\$ (7,041,670)	\$ 52,045,651	

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Share and per share data for all periods presented reflect the effect of the one share for every four shares owned stock split, effected in the form of a 25% stock dividend, distributed on January 30, 2006.

See notes to consolidated financial statements.

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CHARLES & COLVARD, LTD. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2008, 2007, and 2006

	Year Ended December 31,		
	2008	2007	2006
Operating Activities			
Net income (loss)	\$ (6,151,128)	\$ (24,424)	\$ 6,105,335
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization	216,028	200,626	188,757
Share-based compensation	467,104	568,238	316,892
Loss on disposal of long term assets	385,082	44,468	
Provision for uncollectible accounts	2,675,000	1,045,000	78,990
Provision for returns	130,000	(100,000)	160,000
Consignment inventory reserve	185,000	100,000	
Jewelry reserve	220,000	(15,000)	(55,000)
Provision for deferred income taxes	(662,775)	108,584	2,486,960
Changes in operating assets and liabilities:			
Accounts receivable	2,822,062	3,993,953	(3,323,176)
Interest receivable	4,710	8,924	30,036
Income tax receivable	(1,992,229)	(82,191)	
Inventory	(238,851)	(8,577,357)	(8,717,580)
Prepaid expenses and other assets	258,984	24,362	(212,712)
Accounts payable	(1,717,699)	(950,153)	1,539,315
Income taxes payable		(413,387)	404,630
Deferred revenue	171,181		
Accrued payroll	(112,155)	(66,039)	(727,630)
Accrued co-op advertising	(50,943)	(822,249)	(88,966)
Accrued income taxes	2,242,504	(6,018)	
Accrued expenses and other liabilities	210,422	24,434	27,495
Net cash used in operating activities	(937,703)	(4,938,229)	(1,786,654)
Investing Activities			
Purchases of furniture and equipment	(28,910)	(155,864)	(309,139)
Patent and license rights costs	(308,968)	(107,367)	(24,063)
Other	898	1,763	
Net cash used in investing activities	(336,980)	(261,468)	(333,202)
Financing Activities			
Proceeds from exercise of stock options		230,964	245,387
Payment of cash dividends		(1,448,424)	(1,480,360)
Excess tax benefits (cost) from share-based payment arrangements	(186,582)	(297,220)	173,783
Purchase of common stock			(4,059,719)
Net cash used in financing activities	(186,582)	(1,514,680)	(5,120,909)
Net change in cash and equivalents	(1,461,265)	(6,714,377)	(7,240,765)
Cash and equivalents at beginning of year	7,048,409	13,762,786	21,003,551
Cash and equivalents at end of year	\$ 5,587,144	\$ 7,048,409	\$ 13,762,786

Supplemental Schedule of Cash Flow Data

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Cash paid for income taxes	\$	\$ 1,524,281	\$ 876,652
Supplemental Non-Cash Investing Activity:			
Reduction of notes receivable	\$	140,763	\$ 34,610 \$ 113,982

See notes to consolidated financial statements.

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CHARLES & COLVARD, LTD. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2008, 2007 AND 2006

1. Organization and Basis of Presentation

Charles & Colvard, Ltd. (the Company), was incorporated in North Carolina on June 28, 1995 and manufactures, markets and distributes Charles & Colvard created Moissanite jewels (hereinafter referred to as moissanite or moissanite jewels) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral primarily found in meteors. The Company is positioning Moissanite as a unique jewel, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity. The Company began shipping moissanite during 1998 and sells worldwide primarily to jewel distributors and jewelry manufacturers.

All of the Company's activities are within a single reportable segment. The following tables present certain data by geographic area:

Net Sales	Year Ended December 31,		
	2008	2007	2006
United States	\$ 10,286,568	\$ 22,814,219	\$ 36,021,806
International	4,440,486	5,004,227	4,690,279
Total	\$ 14,727,054	\$ 27,818,446	\$ 40,712,085

Furniture and equipment, net	December 31,	
	2008	2007
United States	\$ 412,234	\$ 558,659
International		38,690
Total	\$ 412,234	\$ 597,349

Patent and license rights, net	December 31,	
	2008	2007
United States	\$ 100,397	\$ 117,809
International	178,918	240,521
Total	\$ 279,315	\$ 358,330

2. Summary of Significant Accounting Policies*Principles of Consolidation*

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary in Hong Kong, Charles & Colvard (HK), Ltd. These consolidated financial statements also include the accounts of a Charles & Colvard controlled company in China, Guangzhou Charles & Colvard Trading Limited, a Chinese Corporation. The Company is the beneficial owner of the entire interest in the controlled company, and has consolidated the accounts of the controlled company in its consolidated financial statements. All inter-company accounts have been eliminated. During the year ended December 31, 2008, the Company closed the operations of both its Hong Kong subsidiary and the controlled company in China.

Cash and Equivalents

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The Company considers all money market accounts and investments purchased with an original maturity of three months or less to be cash equivalents.

Inventory

Inventories are stated at the lower of cost or market determined on a first in, first out basis. Inventory costs include direct material and labor, inbound freight, purchasing and receiving costs, inspection costs and warehousing costs. Any inventory in excess of the Company's current requirements based on anticipated levels of sales is classified as long-term on the Company's consolidated balance sheets.

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The Company currently sells one grade of jewel. The grade is classified as very good and consists of near-colorless jewels that meet certain standards. Only very good jewels are valued in inventory. Jewels, including colored jewels, which have not met the Company's quality standards are not valued in inventory. As market conditions change, including the influences of customer demand, there may be a market for a portion of this unvalued inventory that management may pursue in the future.

Obsolescence is not a factor in the Company's inventory valuation. The Company's jewels do not degrade over time and inventory generally consists of the cuts and sizes most commonly used in the jewelry industry. In addition, the Company carries only a limited amount of moissanite jewels in finished jewelry settings as of December 31, 2008. As a result, our inventories are not subject to fashion trends. We have very small market penetration in the worldwide jewelry market and the Company has the exclusive right through 2015 to produce and sell lab-created silicon carbide (SiC) for use in jewelry applications. In view of the foregoing factors, management has concluded that no excess or obsolete inventory reserve requirements exist as of December 31, 2008.

All inventories are carefully reviewed for quality standards before they are entered into finished goods. As the quality of the Company's raw material has improved, so have the standards used to evaluate finished goods. To ensure the Company's inventory meets our current standards, the Company reviews the inventory on an ongoing basis. The Company has provided a reserve to allow for certain jewels of a slightly lesser quality in its finished goods inventory to be possibly re-cut to increase their quality. The need for adjustments to this reserve is evaluated on a period-by-period basis. More details on this reserve are included in Footnote 3.

As of December 31, 2008 and excluding \$840,000 of jewelry on consignment at certain retailers, the Company has a limited amount of jewelry in inventory and does not currently actively market this jewelry inventory. Jewelry inventory value, excluding the items on consignment, is calculated as the amount the Company would obtain by melting the gold in the jewelry and putting the jewels that meet our grading standard back into loose jewel inventory. More details on this reserve are included in Footnote 3.

Furniture and Equipment

Furniture and equipment is recorded at cost and depreciated on the straight-line method based on estimated useful lives of two to 12 years. Leasehold improvements are amortized on the straight-line method over the life of the related lease. The range of useful lives for each category of furniture and equipment is as follows:

Machinery and equipment	5-12 years
Computer equipment	3-5 years
Furniture and fixtures	2-10 years
Leasehold improvements	over the life of our existing operating leases

Patents and License Rights

The Company capitalizes costs associated with obtaining or defending patents issued or pending for inventions and license rights related to the manufacture of moissanite jewels. Such costs are amortized over the life of the patent (generally 17 years). The Company also capitalizes licenses it obtains for the use of certain advertising images. Such costs are amortized over the period of the license.

Accounting for Long-Lived Assets

The Company evaluates the recoverability of its long-lived assets for financial impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be fully recoverable. Based on these evaluations, there were no significant adjustments to the carrying value of long-lived assets in 2008, 2007 or 2006.

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Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash equivalents and trade receivables. The Company maintains cash and cash equivalents with high quality financial institutions and invests in low risk securities, primarily money market funds.

Trade receivables potentially subject the Company to credit risk. The Company's standard payment terms are generally between 30 and 60 days for jewel distributors and generally between 60 to 120 days for jewelry manufacturers. The Company extends credit to its customers based upon an evaluation of the customer's credit history, the customer's payment history with the Company, the customer's reputation in the trade and an evaluation of the customer's opportunity to introduce our jewel to new or expanded markets.

As of December 31, 2008, the Company had trade accounts receivable from Reeves Park of \$4.9 million, or 62% of receivables (not considering the allowances for uncollectible accounts or returns). As of December 31, 2007, trade accounts receivable from Reeves Park was \$6.0 million, or 56% of receivables (not considering the allowances for uncollectible accounts or returns). In March 2008, the Company signed a manufacturing agreement with Reeves Park that allowed Reeves Park to continue receiving orders as long as it paid a specified amount higher than the amount of its new orders. There was also a minimum payment amount to be made quarterly and monthly interest payments that Reeves Park was required to pay. In September 2008, Reeves Park stopped making payments required under the March 2008 agreement. In October 2008, the Company amended the March 2008 manufacturing agreement with Reeves Park and agreed to continue to shipping orders on a 100% prepaid basis if Reeves Park paid for all billings on items sold from consignment as they came due. The Company entered into the amendment to ensure a flow of jewelry to retailers during the holiday season while it continued to pursue collection of the outstanding balance due from Reeves Park. The amendment also provided Reeves Park with the required notice of "good cause" to terminate the manufacturing agreement due to Reeves Park's failure to make contractual payments on their outstanding balance. In November 2008, both the manufacturing agreement and the amendment with Reeves Park were terminated due to Reeves Park's repeated failure to make timely payments for moissanite shipped to Reeves Park. In January 2009, the Company entered into a settlement agreement with Reeves Park to settle the outstanding balance by accepting a return of inventory, the receipt of certain cash payments due to Reeves Park from its customers, and the payment of a settlement fee to the Company by Reeves Park. Based on the \$2.3 million estimated net realizable value of the transactions under the settlement agreement, the Company increased its allowance for uncollectible accounts during 2008 for Reeves Park to \$2.6 million. The majority of jewelry inventory received is valued at scrap value due to the lack of a plan to market this inventory. The majority of the inventory received from this transaction was received in January and February 2009 and is not reflected on the consolidated balance sheets as of December 31, 2008.

The only other customer who accounted for more than 10% of receivables at December 31, 2008 and 2007 was K&G Creations ("K&G"). K&G represents 15% of receivables (not considering our allowances for uncollectible accounts or returns) at December 31, 2008 and 13% of receivables (not considering our allowances for uncollectible accounts or returns) at December 31, 2007. In June 2008, the Company filed a collection action in the United States District Court, Eastern District of North Carolina, Western Division, against K&G for collection of in excess of \$2.8 million owed the Company under an agreement between the Company and K&G that was terminated as of December 31, 2007. The Company seeks to recover approximately \$2.8 million, with interest accruing at the contract rate of 12% from July 4, 2008, for moissanite jewels delivered and sold to the defendant. As of December 31, 2008, the Company has fully reserved the receivable from K&G. No sales have been recorded to K&G during 2008 and K&G represented 11% and 21% of sales during years ended December 31, 2007 and 2006, respectively.

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Sales are also concentrated amongst a few larger customers. See table below showing the percentage of sales for each of our major customers for the years ended December 31, 2008, 2007 and 2006. Any amounts less than 10% are indicated by ^c in the table below.

	Year Ended December 31,		
	2008	2007	2006
Reeves Park		20%	37%
K&G Creations		11%	21%
Stuller Settings	21%	14 ^c %	
SAI		19%	13%
<i>Foreign Currency Translation</i>			

The assets and liabilities of the Company's non-U.S. operations, whose local currency is the functional currency, are translated into U.S. dollars at exchange rates in effect on the balance sheet dates. Revenues and expenses are translated using the average exchange rates in effect during the year. Foreign currency translation adjustments are reflected as a separate component of shareholders' equity in the accompanying consolidated balance sheets in accumulated other comprehensive gain (loss).

Revenue Recognition

Revenue is recognized when products are shipped, excluding memo or consignment shipments as discussed below. At the time revenue is recognized an allowance for estimated returns is established. Any increase or decrease in the allowance for returns is charged against net sales. For all jewels shipped (excluding memo or consignment shipments discussed below) title passes upon shipment of the jewels from the Company's facility (i.e., FOB-shipping point). The Company's return policy is that jewels can only be returned for credit within 30 days of shipment and must be returned for a valid reason (quality problems or a shipment of the wrong jewels). Some customers have a contractual right to return a certain percentage of sales for any reason. In these instances, we only recognize revenue when the contractual right to return is exhausted. Periodically, the Company sells jewels to customers on memo terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. The Company's customers are generally required to make payments on memo shipments within 60 days upon the customer informing the Company that they will keep the jewels. Accordingly, the Company does not recognize revenue on these memo transactions until the earlier of (1) the customer informing the Company that they will keep the jewels or (2) the expiration of the right of return period.

Advertising Costs

Advertising production costs are expensed as incurred. Media placement costs are expensed the first time the advertising appears. Advertising expenses for the years ended December 31, 2008, 2007, and 2006 amounted to approximately \$3,300,000, \$8,700,000, and \$11,000,000, respectively.

The Company also offers a co-op advertising program to its customers that reimburses a portion of their marketing costs based on the customers net purchases from the Company and is subject to the customer providing documentation of all advertising performed that includes the Company's product. For the years ended December 31, 2008, 2007 and 2006, these amounts were \$1,300,000, \$2,300,000, and \$3,700,000, respectively, and are included as a component of marketing and sales expenses. These co-op advertising expenses are included in the advertising expense amounts disclosed in the paragraph above.

Marketing and Sales

Marketing and sales expenses are expensed as incurred. These costs include all expenses of promoting and selling the Company's product and include such items as marketing and sales personnel, advertising, travel, rent, trade shows, market research, and sales commissions.

Table of Contents*General and Administrative*

General and administrative expenses are expensed as incurred. These costs include administrative personnel, legal, investor relations, professional fees, Board of Directors fees, insurance, bad debts and rent.

Research and Development

All research and development costs are expensed as incurred.

Share-Based Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (FAS) No. 123R, *Share-Based Payment*, which requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. The Company adopted FAS No. 123R using the modified-prospective method, which requires compensation cost to be recorded for all unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards with no restatement of prior periods. The Company uses the Black-Scholes-Merton valuation model to determine the fair value of stock options. The fair value of other stock compensation awards is determined by the market price of the Company's common stock on the date of grant. The expense associated with share-based compensation is recognized on a straight line basis over the service period of each award.

The following table summarizes the components of the Company's share-based compensation included in reported net income for the three years ended December 31, 2008 as follows:

	Year Ended December 31,		
	2008	2007	2006
Employee Stock Options	\$ 169,252	\$ 255,462	\$ 200,059
Consultant Stock Options	(154)	(1,304)	(61,072)
Restricted Stock Awards	298,006	314,080	177,905
Income Tax Benefit	(141,213)	(163,707)	(84,683)
Total	\$ 325,891	\$ 404,531	\$ 232,209

In addition, \$3,993, \$5,216 and \$7,585 of share-based compensation were capitalized as a cost of inventory during the years ended December 31, 2008, 2007 and 2006, respectively. Compensation cost on consultant stock options was negative during the periods displayed above due to a reduction in the fair value of stock awards issued to consultants.

As of December 31, 2008, the unrecognized share-based compensation expense related to non-vested stock options is approximately \$63,000, which is expected to be recognized over a weighted average period of approximately 9.5 months.

In May 2006, the Company granted its non-employee board members an aggregate of 27,377 shares of restricted stock. The fair value of the restricted stock granted was \$305,000 based on the closing market price of the Company's common stock on May 19, 2006. These shares vested in May 2007 after the one-year term on the board expired.

In May 2007, the Company granted its non-employee board members an aggregate of 63,806 shares of restricted stock. The fair value of the restricted stock granted was \$305,000 based on the closing market price of the Company's common stock on May 21, 2007. These shares vested in May 2008 after the one-year term on the board expired.

In May 2008, the Company granted its non-employee board members an aggregate of 227,610 shares of restricted stock. The board members cannot sell these shares until their one-year term on the board expires in May 2009. The fair value of the restricted stock granted was \$305,000 based on the closing

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market price of the Company's common stock on May 30, 2008. These are the only unvested restricted stock awards outstanding as of December 31, 2008 for the Company. As of December 31, 2008 unrecognized compensation expense related to non-vested restricted stock was \$124,999 which will be amortized on a straight line basis through May 2009.

The fair value of each option grant is estimated on the grant date using a Black-Scholes-Merton option pricing model. There were no stock options granted during the year ended December 31, 2008. The valuations of options granted during the two years ended December 31, 2007 were based on the following assumptions:

	Year Ended December 31,	
	2007	2006
Weighted-average grant date fair value	\$ 3.72	\$ 6.39
Weighted-average expected lives (in years)	5.50	4.00
Weighted-average risk-free interest rate	4.36%	4.60%
Dividend yield	0%	0%
Volatility factor	.688	.646

The expected life of an option represents the estimated period of time until exercise occurs and the Company generally uses the midpoint of the vesting period and the life of the grant to estimate the expected life of an option. This methodology is not materially different from the Company's historical data on exercise timing. The risk-free interest rate is based on the implied yields on U.S. Treasury zero-coupon issues over the expected life of the option. Although the Company issued dividends in prior years, a dividend yield was not used due to the uncertainty of future dividend payments. Expected volatility is based on the historical volatility of the Company's stock.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Taxes

Deferred income taxes are recognized for the income tax consequences of temporary differences by applying enacted statutory income tax rates applicable to future years to differences between the financial statement carrying amounts and the income tax bases of existing assets and liabilities. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount that is more likely than not to be realized.

Stock Dividends and Stock Splits

On December 21, 2005, the Company declared a one share for every four shares owned stock split, effected in the form of a 25% stock dividend, distributed on January 30, 2006. All share and per share amounts for all periods presented in these financial statements and footnotes reflect these transactions.

Table of Contents*Net Income per Share*

Basic net income per share computations are based on the weighted-average common shares outstanding. Diluted net income per share computations include the dilutive effect, if any, of stock options using the treasury stock method. The following table reconciles the differences between the basic and diluted earnings per share presentations:

	Years Ended December 31,		
	2008	2007	2006
Numerator:			
Net Income (Loss)	\$ (6,151,128)	\$ (24,424)	\$ 6,105,335
Denominator:			
Weighted Average Shares Outstanding			
Basic	18,240,853	18,065,739	18,160,218
Stock Options			502,552
Diluted	18,240,853	18,065,739	18,662,770
Net Income (Loss) Per Share:			
Basic	\$ (0.34)	\$ (0.00)	\$ 0.34
Diluted	\$ (0.34)	\$ (0.00)	\$ 0.33

For the years ended December 31, 2008, 2007, and 2006, stock options to purchase approximately 739,000, 964,000, and 310,000 shares, respectively, were excluded from the computation of diluted net income per share because the options' exercise price was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net income (loss) per share. During 2008 and 2007, no common stock options were included in the computation of diluted earnings per share as the effect would be anti-dilutive due to the net loss. During 2006, approximately 957,000 common stock options with an exercise price less than the average market price were included in the computation of diluted earnings per share. The weighted-average dilutive impact of these options, net of 455,000 treasury shares assumed to be repurchased, was 502,552 shares.

Newly Adopted Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). This standard defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. FASB Staff Position 157-2 (FSP FAS 157-2) delayed the effective date of FAS 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company adopted FAS 157 on January 1, 2008, and utilized the one year deferral for nonfinancial assets and nonfinancial liabilities that was granted by FSP FAS 157-2. The adoption of FAS 157 did not have an effect on the Company's consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (FAS 159). FAS 159 permits entities to measure eligible financial assets, financial liabilities and firm commitments at fair value, on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other generally accepted accounting principles. The fair value measurement election is irrevocable and subsequent changes in fair value must be recorded in earnings. FAS 159 was effective for the Company beginning January 1, 2008. The adoption of FAS 159 did not have an effect on the Company's consolidated financial statements since the Company did not elect the fair value option.

Table of Contents*Newly Issued Accounting Pronouncements*

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (FAS 141R). FAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. FAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. This statement is effective for business combinations occurring on or after January 1, 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No. 51* (FAS 160). FAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. FAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for the Company beginning January 1, 2009. We do not expect the adoption of FAS 160 to have an effect on the Company's consolidated financial statements.

3. Inventories

Inventories consisted of the following:

	December 31,	
	2008	2007
Raw materials	\$ 6,755,863	\$ 6,705,805
Work-in-process	1,969,806	6,245,889
Finished goods	32,851,411	28,326,143
Total Inventory	\$ 41,577,080	\$ 41,277,837

There is \$34,727,841 and \$26,851,837 of the inventory in the table above classified as long-term on the Company's consolidated financial statements as of December 31, 2008 and December 31, 2007, respectively.

Finished goods are shown net of a reserve for jewelry inventory of \$245,000 and \$25,000 at December 31, 2008 and 2007, respectively. A jewelry inventory reserve was established to reduce the jewelry inventory value to the amount the Company would expect to obtain by melting the gold in the jewelry and putting the jewels that meet our grading standards back into loose jewel inventory. Jewelry inventory, net of the \$245,000 and \$25,000 reserve at December 31, 2008 and 2007, was \$208,807 and \$243,110, respectively.

In addition, finished goods are shown net of reserve of \$400,000 at December 31, 2008 and 2007. This reserve was established to allow for the carat weight loss associated with the possible re-cutting of a portion of the finished goods inventory. There are certain jewels in inventory that may be re-cut to achieve higher quality standards. The need for adjustments to these reserves is evaluated on a period by period basis.

4. Inventory on Consignment

Periodically, the Company ships jewels to customers on memo terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. The Company does not recognize revenue on these transactions until the earlier of (1) the customer informing the Company that it will keep or has sold the jewels or (2) the expiration of the memo period if the jewels are not returned. Jewels shipped to customers on memo are classified as inventory on

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consignment on the Company's consolidated balance sheets. Inventory on consignment is shown net of a reserve of \$285,000 and \$100,000 at December 31, 2008 and 2007, respectively. This reserve was established to allow for certain jewels on consignment with customers that are not expected to be returned or may be returned to the Company damaged.

5. Furniture and Equipment/Patent and License Rights

Furniture and equipment, net of accumulated depreciation, is summarized as follows:

	December 31,	
	2008	2007
Machinery and equipment	\$ 532,188	\$ 533,720
Computer equipment/software	708,792	743,834
Furniture and fixtures	209,366	255,866
Leasehold improvements	126,030	126,030
Construction in progress	40,622	40,622
Total	1,616,998	1,700,072
Accumulated depreciation	(1,204,764)	(1,102,723)
Total furniture and equipment, net	\$ 412,234	\$ 597,349

Depreciation expense for 2008, 2007, and 2006 was \$150,994, \$163,416 and, \$154,341, respectively.

Patent and license rights, net of accumulated amortization, are summarized as follows:

	December 31,	
	2008	2007
Patent and license rights	\$ 545,434	\$ 585,410
Accumulated amortization	(266,119)	(227,080)
Patent and license rights, net	\$ 279,315	\$ 358,330

Amortization expense for 2008, 2007, and 2006 was \$65,034, \$37,210, and \$34,416, respectively. Amortization expense on existing patent and license rights is estimated to be \$45,000 for 2009 and \$39,000 per year for 2010 through 2013.

Since 2006, the Company has been party to a lawsuit in South Korea defending its gemstone patent in that jurisdiction. Based on successful court decisions in 2007 and early in 2008, the Company capitalized \$349,000 of legal fees (most of the fees were incurred during 2008) as patent and license rights. However, based on a negative decision received in December 2008 in this matter, the Company recorded a loss on disposal of \$322,000 in 2008.

6. Accrued Expenses

During the year ended December 31, 2008, the Company reduced staffing levels resulting in severance expense of approximately \$659,000. This expense is included in operating expenses on our Statement of Operations. As of December 31, 2008, there was \$227,000 of this severance pay included in accrued expenses and other liabilities on the Company's consolidated balance sheets.

7. Common Stock

In March 2006, the Board of Directors authorized a repurchase program for up to 1,000,000 shares of the Company's common stock. Repurchases were made in the open market at prevailing prices or in privately negotiated transactions at prices at or below prevailing open market prices. This program expired in March 2007. There were 415,000 shares repurchased under the program at an average price of \$9.78. All

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of these purchases occurred during the year ended December 31, 2006.

In April 2007, the Board of Directors authorized another repurchase program for up to 1,000,000 shares of the Company's common stock. Repurchases could have been made in the open market at prevailing prices or in privately negotiated transactions at prices at or below prevailing open market prices. This program expired in April 2008. There were no shares repurchased under this program.

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8. Preferred Stock

The Company has authorized 10 million shares of preferred stock, no par value. The preferred stock may be issued from time to time in one or more series. No shares of preferred stock have been issued as of December 31, 2008.

On February 21, 1999, the Company adopted a Shareholder Rights Plan under which all shareholders of record as of March 8, 1999 received rights to purchase shares of a new series of Preferred Stock (the Rights Plan). The Rights Plan, as modified by an amendment dated February 18, 2009, remains in full force and effect. The adoption of the Rights Plan is intended as a means to guard against abusive takeover tactics. The rights will be exercisable only if a person or group acquires or announces a tender offer to acquire 20% or more of the Company's common stock. Under the Rights Plan all shareholders except the purchaser will be entitled to acquire the Company's common stock at a 50% discount. The rights will trade with the Company's common stock, unless and until they are separated upon the occurrence of certain future events.